Issue 10

HERITAGE
WEALTH ADVISORS

WEALTH MATTERS

Estate Taxes And The New Administration

Income tax hikes during a recession are risky, and the new Barack Obama administration now seems inclined to postpone raising taxes on the earnings of the wealthy. Rather than chance hindering economic recovery, the Democrats who control the White House and Congress may simply let the Bush income tax cuts expire after 2010. But that approach isn't likely to extend to the federal estate tax. Even its temporary elimination in 2010 probably won't happen, and though the size and shape of future levies on inheritances remain uncertain, some experts expect a permanent tax with an equal or lower exemption level and equal or higher rates than those in effect for 2009.

In January, as the new Congress debated details of a massive economic stimulus plan, the Senate Finance Committee was mulling ideas for heading off the 2010 estate tax repeal, and President Obama was expected to include a plan for the tax in his administration's first budget proposal.

During the presidential campaign, Obama had suggested he was open to freezing the estate tax at 2009 levels. Estates of people who die this year will be able to exclude up to $3.5 million from federal estate tax, and estates that exceed that ceiling will be taxed at a top rate of 45%. Those figures are the culmination of a process that began in 2001, when Congress created a plan to eliminate the estate tax by 2010. But that law expires at the end of 2010, with the exemption scheduled to drop all the way to $1 million and the top tax rate to rise to 55% in 2011.

After 2001, the Bush administration and Republicans in Congress tried several times to push through permanent estate tax reform. But two competing agendas hindered those efforts. Owners of family farms and small businesses were focused on the size of the estate tax exemption, urging that it rise as high as $10 million, thus sparing all but a handful of farms and businesses from estate tax liability. Arrayed against those interests were the nation's wealthiest families; resigned to paying some tax—because the amounts they transferred to the next generation would inevitably exceed virtually any exemption level—they wanted a tax rate as low as the 15% that currently applies to long-term capital gains. A compromise proposal from Republican Senator Jon Kyl of Arizona, which called for an exemption of $5 million and a tax rate of 35%, drew 50 votes in the Senate in 2008 but failed to make it into law.

Unlike an income tax hike, which could lead to job losses and reduced economic activity, a new estate tax law should have little effect on the economy, particularly if it keeps 2009's relatively generous $3.5 million individual exemption, which is 75% higher than the $2 million exemption in effect in 2008. Moreover, the estate tax, even at lower exemption levels, affects a very small segment of the population. According to

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Market Corner

By Steve Cooke

The government-led stimulus programs that have been in place for the past 12 months or so have dramatically altered the economic environment, particularly the level of liquidity present in the economic system. At some point, it will be necessary for the central banks to begin removing this stimulus from the economy.

It is evident the Federal Reserve is waiting for indications that the recent improvements in economic growth are sustainable. As confidence builds, it is likely central bankers will fashion a plan to reduce liquidity. Depending on the methods put into place, these actions may adversely impact parts of the capital markets, in particular fixed-income assets.

With the potential that the Federal Reserve will begin the process of reducing liquidity in the system, we believe investors should consider reducing the duration and increasing the quality of their fixed-income portfolios. Additionally, we believe it makes sense to diversify away from Treasury bonds into high-quality bonds outside of the Treasury space. We are currently implementing some of these changes within client portfolios.

As always, we appreciate the opportunity to discuss potential investments with you and are pleased to help you identify whether they are appropriate for your portfolio.

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Four Steps *Not* To Take Right Now

As the tough economic times push on and stock prices fluctuate, it's hard to know what moves to make as an investor. Though the panic you probably felt during the early months of the bear market may have ebbed, your account balances still aren't fun to look at, and the direction of the market is anything but certain. Was the spring-summer market rally the first leg of a new long-term bull market? Or will unemployment, lackluster corporate profits, and a shift from consumer spending to saving post-pone the recovery and keep share prices volatile?

Definitive answers may be a long time in coming. But in the meantime, there's no reason to abandon the fundamental investing principles that have worked for you in the past. Here are four moves *not* to make now.

1. Keep your money idle. It's tempting to sit on the sidelines while the markets sort themselves out. But there are two problems with that approach. The first is that if you're going to reach your retirement goals, you'll need growth in your portfolio, and that means putting your money to work in suitable investments. The second is that if your plan is to sit out until markets improve, you'll inevitably miss much of what the market provides. The best time to buy is when the market is down, not when you feel comfortable, and trying to time your entry and exit into the market almost never works.

2. Chase the golden goose. Trying to get well in a hurry by jumping on the bandwagon for high-flying stocks or high-yielding bonds is another common investing mistake. The best time to invest in a particular sector or category is before a market run-up, not after. You'll probably be too late to the party if you invest heavily when substantial gains have already been realized, and you may be left holding overvalued investments vulnerable to sharp declines, especially while the markets remain volatile.

3. Rely too much on "safe" investments. Diversifying your portfolio with reasonable allocations to low-risk, low-return investments such as bonds and money markets is smart, but veering too far in that direction can be just as damaging to your long-term prospects as chasing hot stocks or trying to time the market. "Safe" investments bring their own risks, including a loss of value when interest rates rise and inflation picks up.

4. Stop saving for retirement. When times are tough, paying bills may have to take precedence over saving. But your future needs are also crucial, and continuing to contribute to your 401(k) or other retirement plan—even, or especially, if its value has plummeted—is the only way to ensure that you'll reach your long-term goals. These turbulent times too shall pass, and it only makes sense to keep working toward your ultimate objectives. In fact, cost averaging into your 401(k) enhances returns when the market drops—a reward for continuing to save. ●

A SCIN Is A Timely Estate Tax Strategy

If there's a single, central objective of most estate plans, it's to transfer property to younger family members while minimizing estate and gift tax liability. Among the many strategies and structures designed to accomplish that goal, one less well-known vehicle—a self-canceling installment note, or SCIN (pronounced "skin")—may work particularly well with today's depressed asset values and low interest rates.

With a SCIN, you sell real estate, a business interest, or other assets to one or more younger family members, such as your children, in exchange for an installment note with a term shorter than your expected life span. That aspect is required; to realize tax benefits, the note's term must be shorter than the seller's life expectancy, according to IRS tables. But under the "self-canceling" feature of the note, your heirs' obligation to repay the loan automatically disappears if you die before the end of the term.

A SCIN provides several potential tax benefits. If you die early and there's an unpaid balance on the loan, that amount won't be considered part of your taxable estate. Yet the property still ends up in the hands of your heirs. And because the transfer is a sale for fair value, not a gift, there's no gift tax.

There's also an advantage in using a SCIN to pass along property that has appreciated in value. Though you may owe capital gains tax on the sale, you can spread out that liability over the note's term. (Note that if the assets' buyers are family members, they must wait at least two years to sell the property in order for the capital gains to be prorated and deferred.) The longer term might help you avoid moving into a higher tax bracket, particularly if the term of the loan

College Savings Plans For A Grandchild

Let's say you've managed to reach retirement in great financial shape. Your home is paid for, you have plenty of money available to travel and enjoy your hobbies, and you've accumulated enough funds to provide security for the rest of your years. What's more, your children are out on their own and doing reasonably well. It may seem as if you've addressed all of your major financial obligations. Chances are, however, that your children could still use your assistance, especially when it comes time to pay for their offspring's college education.

According to the College Board, the average cost of tuition and fees at a private college for the 2008-2009 school year was $25,143, up 5.9% from the previous year. And the cost of attending many top private schools can be much higher. Moreover, with inflation in college expenses outpacing overall price increases each and every year, it's tough even to guess how much college will cost by the time your grandchildren matriculate.

But if you'd like to help with that major future expense, you don't have to wait until the tuition bills come due. You can set up a Section 529 college savings plan now that will pay some, most, or all of a grandchild's education costs. Every state offers these plans, and most are open to non-residents as well.

There are actually two types of 529 plans—prepaid tuition plans and investment plans. With a prepaid tuition plan, you pay for future tuition in today's dollars. Most of these cover costs at state schools; if current tuition is $10,000, for example, a contribution of that amount now will be guaranteed to pay 100% of a year's tuition whenever your grandchild enters school. But most grandparents opt for investment plans that offer greater flexibility, though without a tuition guarantee. If the plan investments perform well, the returns could potentially match or beat annual tuition increases, but they could also lose value if the underlying investments depreciate as they did in 2008 and early 2009.

Most plans offer multiple investment options that may include a target-date portfolio (based on the year a child will enter school) that gradually adjusts allocations from a stock-heavy mix during the early years to a more conservative strategy as freshman year approaches. Other state plans manage 529 money alongside state pension assets, while still others let you set your own asset allocations.

Each state establishes the contribution limits for its own college savings plans, but the caps tend to be generous, reflecting the high future cost of college. Also, though many people believe otherwise, plan beneficiaries aren't required to attend school in their home state. The full value of the account may be used at any accredited college and university in the country—and even at selected foreign institutions.

If you set up a plan for a grandchild who doesn't go to college, you can roll over the funds tax-free into an account for a different beneficiary, such as another grandchild. But distributions from the account must begin when the eventual beneficiary reaches age 30.

In all 529 plans, earnings accumulate tax free for both federal and state purposes, and distributions are exempt from federal and state income tax as long as the funds are used for qualified educational expenses. Many states also offer state tax deductions or credits to residents who choose their plans.

If plan funds are withdrawn for other uses, earnings on plan distributions will be taxed at ordinary income rates, and there will also be a 10% federal penalty unless the beneficiary has died, become disabled, or doesn't need the money because he or she received a scholarship. States may assess additional penalties.

Finally, though your contributions to a Section 529 plan are considered gifts, you may give up to $13,000 a year without gift tax consequences to one or several beneficiaries. And if you're married, your spouse can kick in another gift-tax-exempt $13,000 per grandchild. Moreover, special rules for 529 plans let you make five years of contributions in a single year. That's a total of $65,000 per spouse for each beneficiary. Want to establish 529s this year for three grandchildren? Together with your spouse you could give $130,000 per child, or a total of $390,000, without owing gift tax.

The bottom line is that helping with your grandchildren's college costs not only reduces the burden on your children; it also reduces the size of your taxable estate. That makes this option worth considering as part of your overall estate plan. We urge you to discuss your goals with us and also with your children so that funding college is a coordinated effort of all parties. ●

extends into your retirement years, when your income may be declining. Meanwhile, if the transferred property continues to appreciate, those gains will be outside your estate.

Because the self-canceling aspect of a SCIN is a risk to your estate, the note must include either an inflated market value for the assets or an interest rate that's higher than the applicable federal rate, or AFR. That can be a drawback of this estate planning technique. But interest rates now are exceptionally low, and the value of most assets is well below what they may have been worth in recent years. As a result, the interest rate required for a SCIN may still be quite reasonable. And with asset values depressed, the principal of the note will be lower, and any rebound in prices will, again, occur outside your estate.

If you are interested in transferring property to your heirs, we can work with you and your attorney to consider whether a SCIN could help. ●

Red Flags Raised By Madoff's Scheme

The recent revelations concerning Bernard Madoff's "Ponzi scheme" have put the fear of fraud in investors. Even if you never came anywhere near Madoff Securities, you may sympathize with those who reportedly were bilked out of billions of dollars. And you'll probably wonder whether something similar could happen to you.

According to Madoff's indictment, his truly was a scandal for the rich and famous, who were drawn in not by a chance to make a quick killing but by rock-steady annual returns of 10% to 12% regardless of the state of the markets. Although there are no guarantees that any financial manager is on the up-and-up, a closer examination of Madoff's operation would have revealed several "red flags," giving investors pause.

The mere fact that he had an unwavering track record should have been the first and biggest warning sign. Normally, even the best-diversified portfolios will rise and fall with the markets; the hope is merely for a smoother-than-normal ride and better-than-average results. In addition, Madoff took the unusual step of assuming full custody of client assets, rather than using a nationally recognized custodian. That, too, should have set off alarm bells. But there were also other problems.

Madoff's books were audited by a little-known accounting firm. That's extremely unusual for such a major investment company. Normally, big investment managers use a Big Four national accountant or at least a prominent regional firm—and investors thinking about entrusting Madoff with millions of dollars in assets should have been wary.

The lack of information on Madoff's website and in his brochures was telling. There was nothing about the qualifications or designations of the firm's money managers, and scant information about Madoff's process for managing assets. If investors had compared these marketing materials to those of other, more forthcoming investment firms, they might have been more inclined to question Madoff's apparently remarkable results. Those who did try to decipher how Madoff worked his magic found they couldn't replicate his results—it just seemed impossible to deliver that kind of performance. It was.

There was no evidence of diversification. The kind of astonishingly steady returns Madoff used to attract investors, if feasible at all, should require broadly spreading assets over many kinds of investments and regularly rebalancing to keep investment risks under control.

As more details about Madoff's dealings emerge, investors may get a clearer picture of what went wrong. In the meantime, the scandal reminds everyone that there are no shortcuts to investment success, and that when results seem too good to be true, they almost always are. ●

New Administration

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Citizens For Tax Justice, an advocacy group, only 18,431 of the 2.4 million Americans (0.8%) who died in 2004 left behind any estate tax liability. And that was when the exemption amount was $2 million less than it is today.

Against that backdrop, the Obama administration apparently sees few economic or political risks in seeking an estate tax law that would forgo the one-year repeal scheduled for 2010. And some estate planning experts believe that an administration and Congress overwhelmed by red ink could push for estate tax rules less generous than those in place in 2009. Attorney Gideon Rothschild of Moses & Singer, LLP, can imagine a new estate law that would affect significantly more taxpayers than are subject to current rules. And according to Rothschild, Washington insiders are also looking at other possible estate planning changes. These include:

- The elimination of qualified personal residence trusts (QPRTs) as a tool for avoiding estate taxes on the value of a family home.
- Changing the rules for grantor retained annuity trusts (GRATs), used to reduce gift and estate taxes on property transferred to trust beneficiaries, so that gift tax will be owed on at least 10% of the value of the transferred assets.
- Outlawing valuation discounts associated with family limited partnerships (FLPs) except when the partnership involves an active business.

- Portability of the exemption between spouses which would allow a surviving spouse's estate to apply any unused exemption of the predeceased spouse.

With change on the way for federal estate tax laws, this is a good time to revisit your own estate plan. Estate legislation could pass this year, and as Rothschild points out, there's nothing to stop a new law from being made retroactive for 2009. We can work with you and your attorney to make sure your financial and estate plans are prepared for whatever comes. ●

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