WINTER 2011

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

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Estate Tax Update

In the fall of 2010, individuals began to wonder if Congress would address the estate tax gap that occurred when the estate tax law expired at the end of 2009, leaving no estate tax in place for 2010. In December 2010, Congress addressed the gap, unifying the estate tax with the gift tax for the years 2011 and 2012. The following provides a general overview of the legislation.

With the new law, the top estate tax rate is 35 percent with a $5 million estate tax exemption. The gift tax exemption is $5 million (from $1 million) with a 35 percent gift tax rate. The generation-skipping transfer tax law is $5 million with a 35 percent gift tax rate.

Although 2010 began with no estate tax in place, the general presumption with this newly enacted law is that estate tax applies to all estates in 2010. While individuals can choose to affirmatively elect out of the estate tax for 2010, they would then be subject to modified carryover basis. This is the only year that modified carryover basis is an option.

IRAs have become more vibrant under the new law. There is a charitable giving provision in the law that includes a retroactive extension of the IRA charitable rollover provision for 2010 as well as an extension of the provision for 2011. This means anyone over the age of 70.5 years who was obligated to take required minimum distributions may instead make tax-free IRA gifts, up to a maximum of $100,000 per year, subject to certain guidelines.

2010: Variations on a Theme

Was 2010 a year of cautious optimism, or a year to be alternately cautious and optimistic? At times during the year, investors found reasons to be all of the above. Consider some of the year's events:

- New claims for unemployment fell sharply, down to 420,000 for December, down from 504,000 experienced in August.
- The index of leading indicators rose 1.1 percent in November, the fifth straight month of increases.
- November and December retail sales rose 0.6 percent and 0.8 percent, respectively, the third increase in the last four months.
- The Federal Reserve continued to pursue a very accommodative monetary policy, keeping the federal funds rate basically at zero. And even with the better economic news, the Fed announced the expansion of its quantitative easing (bond buying) program.
- The uncertainty over tax rates for 2011 was eliminated when Congress passed the extension of the Bush tax cuts. Tax cuts were put in place and more stimulus spending was enacted, but no plans were made to pay for any of the costs.
- Projections for the federal budget deficit skyrocketed — and along with it fears that rising inflation was inevitable. This led to a dramatic increase in commodity prices, especially gold, which increased from just over $1,100 to about $1,400.

Where Do We Go From Here?

Even as we gain mental distance from the financial crisis of 2008, our general proximity to those events remains front and center. The U.S. economy continued to struggle in 2010. The November unemployment rate of 9.8 percent was actually higher than the January 2010 rate of 9.7 percent, but it fell to 9.4 percent in December. More banks failed in 2010 than failed in 2009 (157 compared with 140). This was the largest number of failures since 1992 during the height of the savings and loan crisis.

Europe experienced a series of severe financial crises in what could be called a contagion. In 2010, Greece and Ireland had to be bailed out while there were ongoing concerns that Spain and Portugal could be next.

Finally, as bad as the housing market was in 2009, it continued to weaken. Sales of new single-family houses fell to a seasonally adjusted annual rate of 290,000 in November, more than 20 percent below the 368,000 sales rate in November a year ago. The actual number of homes sold in November was 21,000, the lowest monthly sales figure on record.

Individually, each of these items would be viewed as negative for the U.S. stock market. Collectively, it would surely seem that they would send the market reeling. Yet, despite this collective tale of woe (with the occasional bright spot), investors in U.S. stocks were well rewarded.

Especially well rewarded were those who invested in the riskier asset classes of small and small value stocks, which had returns that were well above historical averages. The same was true of REITs, despite the aforementioned housing market problems and the well-documented problems in commercial real estate.

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Quantitative Easing and Inflation

By Heber Farnsworth

What is a quantitative easing? The term isn't very well defined, but what it boils down to is the Federal Reserve Board wants to increase the cash reserves of banks. The way it does this is by purchasing securities (usually Treasury bonds). For example, if the Fed buys $1 million worth of bonds, the cash ends up in the sellers' bank accounts. Upon receiving this new deposit of money, the banks collectively have an extra $1 million to lend. Of course, that is the idea: to get banks lending again. Quantitative easing simply means the Fed is planning on doing this on a massive scale, $600 billion in total, over a period of several months.

Ever since the Fed announced its second round of "quantitative easing," the airwaves and online commentators have been busy forecasting the future. Recently, one economic prognosticator predicted an impending hyper-inflation. This type of doomsday scenario has scared some people.

Rather than analyzing the rather dubious reasoning behind that forecast, let's ask whether this is a widely held belief or whether it represents a fringe view. If it is widely held, then it would affect prices of traded securities, which can tell us the perspective of "the market." We have a way to determine what the market expects for future inflation.

In the bond market, there are two types of U.S. Treasury bonds traded. Nominal bonds are bonds whose future payments to investors are fixed. Treasury inflation-protected securities (TIPS), also known as inflation indexed securities, are bonds whose future payments depend on inflation. The yield of the Treasury bond minus the yield of a TIPS is what we call "break-even inflation." If inflation ends up higher than this amount, then TIPS will outperform nominal bonds, and vice versa if inflation is lower. Break-even inflation is what the typical bond market participant expects inflation to be over the life of the bond.

For most of the last 10 years, break-even inflation has hovered between 2 percent and 3 percent. During the financial crisis of 2008, it briefly fell into negative territory. In early 2010, break-even inflation fell to 1.2 percent. When the Fed announced the quantitative easing would occur, break-even inflation rose to about 1.5 percent, but it has since risen to about 1.8 percent. Of course, actual inflation may be higher or lower than this number. So, although a small group of individuals have forecasted significantly high inflation in the near future, the bond market seems to be telling us something very different.

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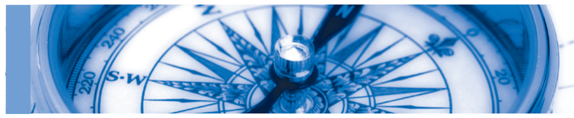
Something to Take With You

The message that bears repeating as we move into 2011: There is a major difference between the economy and the market. The mantra of staying the course becomes somewhat easier when you realize the economic events of the day will not automatically swing the market. The world is a risky place, but those with perspective will acknowledge this is not a new condition, only different variations on the same theme.

Perseverance in life and commitment to an investment plan both require strength of character. Each year, that same character enables us to say farewell to one year and bravely begin another with fortitude and grace.



Making Plans

Five Things to Consider for Your 2010 Income Tax Return

By Cathy Goldsticker, CPA

Which year should you report your Roth conversion income?
Since the income tax rates for the 2011 and 2012 tax years are the same as 2010, and if your other income and deductions remain constant, it should be beneficial to defer the income until the later years and earn interest on these deferred tax payments. This decision whether to pay your income tax liability when submitting your extension request or when filing your 2010 income tax return should be made by April 18, 2011 (April 15 is a holiday in the District of Columbia). You have until October 17 to decide (October 15 is a Saturday), but if the proper tax payments have not been paid by April 18, you may be subject to underpayment penalties.

How can you manage your alternative minimum tax (AMT) bill?
Make sure expenses, such as professional fees and taxes, are properly reported to allow full deduction for both regular tax and AMT. Also, confirm your AMT reported exemption reflects the latest tax law change and look for prior years' AMT tax credits that can reduce your 2010 tax bill.

Have residential energy saving costs been examined for tax credits?
Expenses such as replacement windows, heating equipment and doors can provide significant tax credits, as do alternate energy source expenditures.

Are passive activity rules deferring loss recognition for your business investments?
Make sure the exceptions to these rules have been used to allow early tax benefits on the losses to be received. If you have prior years' suspended losses, they may be deductible for 2010.

Have retirement plan contributions been maximized?
Consider contributions on your outside income for you and your spouse. Current deductions make sense if the retirement income will be taxed at a future lower tax rate during your retirement.

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This information is meant to raise awareness on the topic addressed and should not be considered tax advice. It is always important to consult a tax planner before engaging in actions that may have tax consequences.

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