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Estate Tax Exclusion Poses Opportunities and Challenges

The new federal tax law ushered in the highest estate and lifetime gift tax exemptions in U.S. tax law history: $5 million for individuals and $10 million for married couples. While this may appear to have taken off the pressure for careful estate planning - only 1% of U.S. estates are estimated to be larger than $5 million - the higher limits pose both opportunities and challenges for high-net-worth families.

Given the new law, here are some estate planning considerations married couples should address:

Change charitable donations? - The single most obvious benefit of the higher estate tax exemption is that if planned properly, as a couple, you can now leave substantially more - $10 million instead of $2 million - to heirs and relatives. This is most significant to those whose primary reason for charitable giving is to reduce taxes. Given the new law, reviewing your purposes and strategy should be your first priority.

Accelerate and increase gifting? - For couples who have exhausted the previous unified gift tax exemption of $2 million, the $10 million limit represents an unprecedented opportunity to move assets out of their estates without taxation. Keep in mind, however, that the annual limit on tax-free gifts is only $13,000 in 2011, $26,000 if a couple splits their gift.

Since the new tax law expires in 2013 and it's uncertain what future exemption limits will be, it may be a good idea to take full advantage of the higher limits over the next two years. Targeting appreciating assets - like stocks and real estate - should be the first priority; even if Congress reduces the exemptions after 2012, once those assets are out of your estate, any appreciation on those assets is also out of your estate.

Trust or will? - The higher limit means you can avoid establishing trusts to remove greater funds from your estate. One disadvantage of testamentary transfers to beneficiaries is you lose control over how and when the funds are distributed. Wills must still pass through probate, which means there is the potential for considerable delay before your heirs gain access to the assets they may need to pay taxes or other bills. Wills also distribute assets without limitations as to the purposes they can be used for or when, such as reaching the age of majority or annual distribution amounts. Only trusts can establish these directions.

Understanding the new portability provision - One new feature of the tax law concerns "portability" of the estate tax exemption between spouses. Under this provision, any credit that has been unused by a deceased spouse can be transferred to the estate of the surviving spouse.

For example, if a spouse's estate used only $2 million of the $5 million exemption, the remaining $3 million can be applied to the surviving spouse's estate, raising its exemption to $8 million. But there are two important caveats: 1) It's not automatic. Even if an estate won't owe a penny in federal estate taxes, it must file a tax return to establish the transferred credit. 2) Portability does not apply to generation-skipping trusts, whose beneficiaries are grandchildren and great-grandchildren.

If the surviving spouse is predeceased by more than one spouse, the additional exclusion amount carried over to the surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last deceased spouse.

Avoiding unintended disinheritance - Because estate laws are constantly changing, when it comes to dividing assets among different heirs, many wills and trusts rely on a "formula clause" that doesn't specify dollar amounts or percentages. For example, a document may simply say that children of the deceased are to receive the maximum amount allowed to pass to them free of federal taxes, with the remainder going to the surviving spouse. For an estate that is $5 million or less, this means the spouse is effectively disinherited. Adding further clarification in such cases is vital to ensuring that an intended beneficiary isn't left penniless.

Lower state thresholds - Be aware that more than a dozen states also levy inheritance taxes, and the threshold of taxability may be considerably lower than the federal level.

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It's Time to Review Your Estate Plan

Estate plans should be reviewed periodically to ensure that their objectives are still being met. And now, with major changes in the tax code that affect estates, it's important that you revisit your estate plan as soon as you can.

In general, here are guidelines as to why and when you should take another probing look into how you can best pass your assets down to your beneficiaries and charities of your choice.

Tax laws change - The last three years have been among the most volatile in terms of the federal tax code's effects on estates. New federal laws reestablished estate taxation after a year of zero taxation, introduced new features that affect married couples, and changed the gift tax exemption limits. Without reviewing and redesigning your estate plan in view of these changes, it's almost certain that should you or your spouse die this year, there will be some unplanned consequences and missed opportunities. And none of this even takes into account any new or proposed changes in any state inheritance tax you may be subject to.

Asset values change - Even more dramatic than the state of the U.S. tax code, asset values have undergone their most dizzying changes since World War II. Real estate prices are off as much as 50% to 60% from their peaks in 2006 (Source: *Realty Times*, 2011). Meanwhile, the Dow Jones Industrial Average and the Standard & Poor's 500 indexes have fluctuated significantly over the past few years, and individual stocks and bonds have been even more volatile. As a result, the total value of assets in estates and funded trusts may have shrunk or expanded significantly and may now be way out of tune with the new unified credit exemptions.

Life changes - Are you and your spouse earning the same amount of money and in the same health as you were the last time your estate plan was finalized? Are you still married to the same person? Do you still have the same number of children and heirs? Such changes happen as often as several times a year. If you have a backlog of changes not yet reflected in your plan, there's no good reason to wait any longer.

Causes change - If charitable giving is part of your plan, there are several reasons your plan may need to be updated. The causes you want to support may have changed, new charities may have arisen that interest you, or the financial state of the charities you support may have become more dire or more flush.

Despite the fact that an estate plan deals with your passing, to be consistent with your wishes and concerns, the best guideline is to consider it a living document that needs periodic reassessment.

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Roth IRAs: Are They for You?

Unlike a traditional individual retirement account (IRA), contributions to a Roth IRA are taxed while the earnings accumulate tax free. What's more, a Roth IRA can be funded with new money or converted from a traditional IRA. But is it for you?
Are you worried about an increase in tax rates? Many experts are concerned that rising deficits will force Congress to raise taxes. By investing in a Roth IRA before any potential tax increases, you can take advantage of current tax rates. This beats the traditional IRA where you would be paying taxes at a higher rate when you make a withdrawal in the future, except that most people fall into a lower tax bracket when they retire. Also consider this: if you convert your assets into a Roth IRA, it could take 15 to 20 years for the tax-free growth of a Roth IRA to make up for the taxes paid at the time of conversion. Or even longer if you make regular withdrawals from the account.

In other words, depending on your age, how close you are to retirement, and your preretirement and post-retirement income levels, the tax benefits of a Roth IRAs may or may not make sense for you.

How do the new rules affect you? One of the reasons Roth IRAs have become more attractive recently is because of their new income restrictions - or lack thereof. In the past, anyone making more than $100,000 a year couldn't convert their traditional IRA into a Roth. Starting in 2010, they can.

The law hasn't, however, impacted annual contribution limits. The maximum annual contribution allowed for a Roth IRA remains $5,000 for anyone under 50 years old and $6,000 for investors 50 or older.

Does passing on wealth matter to you? A benefit of Roth IRAs is that you can pass the balance on to your beneficiaries tax free. Additionally, there are no minimum withdrawals required for a Roth IRA - you can take advantage of tax-free growth for as long as you like.

Consider this example: a grandmother passed away shortly after converting $30,000 to a Roth IRA. She named her six-year-old granddaughter as her beneficiary. The granddaughter begins withdrawing the minimum amount each year. Assuming the investments in the grandmother's Roth IRA earn 8% per year and the granddaughter continues withdrawing just the minimum amount required each year by law (IRS rules give a six-year-old 75 years to empty an inherited IRA), the granddaughter will receive $2.1 million from the $30,000 her grandmother converted to the Roth IRA. And every cent will be income tax free

(Source: Fox Business, 2010). *(This example was provided for illustrative purposes only and is not intended to project the performance of a specific investment vehicle.)*

But Is It for You?

Roth IRAs clearly offer a number of attractive benefits when compared to traditional IRAs. But those benefits are a tradeoff: pay taxes now or pay them when you're retired. Consider whether the benefits of a Roth IRA - including the comfort of paying taxes today at a known rate - really matter to you.

Roth IRAs are just another option when investing for retirement. Because everyone's financial picture is different, you should take the time to carefully review your situation and to determine if a Roth IRA is for you.

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When Should You Retire?

Most people know instinctively that deciding when to retire is one of the most important life decisions they'll ever make. What most people don't know, however, is how to actually make that decision.

The "traditional" retirement age is 65. But some people want to retire early, say, at age 55. Others look at how much they'll get from Social Security - benefits begin at age 62, but the longer you delay, the more it pays out. Then there's the matter of your retirement portfolio - with many retirement portfolios lower than they were a few years ago due to stock market fluctuations, many people are wondering if they might have to put off retiring far longer than they had expected.

The most important question to answer is: how many years can you afford the lifestyle you want in retirement? The worst thing that can happen is that you run out of money in retirement. The best idea is to work with a qualified financial planner to answer this question. But to give you an idea of what's involved in making that decision, here's a summary of the main considerations:

What is your lifestyle going to cost in retirement? This is the most basic parameter to determine. Is your house paid off? Are you going to travel and entertain frequently? Do you want to own two homes, one in a warmer climate for the winter and a cooler one for the summer? What will the cost of living be in each of those places? What kind of uncovered medical expenses do you expect? Start by putting together an annual household budget for all of your expenses.

What sources of income will you have? Will it be only Social Security or will it include other regular payments, like from a pension, consulting or self-employment, rental income, royalties, and the like?

How much do you have accumulated, and what annual income can you generate from it? Sources of retirement savings often include IRAs, 401(k) plans, and taxable accounts.

Will your income cover your expenses? If so, you *might* be able to retire at the age you project. If the rate at which you withdraw money from your retirement portfolio is too high, however, you run the risk of

depleting those resources before you die, which will likely result in making some very uncomfortable adjustments to your lifestyle.

If you determine that your income won't cover your expenses, there are three solutions:

- Delay retiring while you add to your personal savings, and increase the amount you can collect from Social Security.
- Change the investment mix in your portfolio to potentially increase your rate of return.
- Aim for a less-expensive retirement lifestyle.

A thorough financial plan runs through all of these calculations and aims at a realistic answer to the question of when you should retire, based on all the details of your finances and the level of risk that's appropriate for you.

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Coping with the College Debt Crisis

America reached an ominous milestone last year. For the first time in history, U.S. student college debt exceeded credit card debt. According to the Project on Student Debt, a nonprofit research center, college and graduate students are adding education debt at the rate of $2,853.88 per second, which means they will reach the $1 trillion mark sometime next year.

These figures alone don't reveal the full significance of this crisis: thousands of graduates are saddled with debt they can't afford to pay without making choices about which necessities to forgo. Student default rates have doubled since 2005, according to the U.S. Department of Education, and represent another potential landmine threatening the economy.

To more sharply define the issue, in 2009, the average college student graduated with an education loan debt of $24,000, up 6% over the prior year. Debt loads for graduates of private colleges are higher, and it's not unusual for college graduates to leave school with more than $100,000 in debt and monthly payments of $700 or more. For many recent graduates, the weak economy means they are either unemployed or underemployed and unable to keep up with even minimal payments.

For graduates with large amounts of private loan debt, there is little they can do - the law makes it extremely difficult to discharge educational debt via bankruptcy. Debt consolidation - one avenue previously open - has since been severely limited by the decrease in the number of banks willing to extend private loans. At best, holders of private loans can ask to lengthen the terms of their loans, but many lenders are reluctant to make even that concession.

Holders of federally guaranteed loans have more latitude. Since July 1, 2009, graduates have been eligible to apply for the Income-Based Repayment Plan. Under the terms of this program, the federal government agrees to limit annual repayment to no more than 10% of a graduate's income. Single people with less than $50,000 of income and married couples with two children and less than $100,000 in joint income are eligible.

Meanwhile, federal loan programs offer graduates other forms of relief, including a graduated repayment program, extended repayment terms of up to 25 or 30 years, and the option to have payments suspended because of financial hardship.

The best form of relief, however, is prevention. Parents should caution their students against taking out large loans, especially private loans. Before deciding whether to enroll in a college or university, it would serve parents and students well to project how much they might need to pay the bills.