The
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Estate Taxes And The Obama 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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John R Day Bill Ennis

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. ●

College Savings Help Admission Chances

If you need a little extra motivation to set aside college savings each month, consider this: With a volatile stock market taking a bite out of college endowments, financial aid budgets are shrinking and assistance will be harder to come by. Worse, many colleges are choosing not to admit students who need aid.

Today, relatively few schools have the financial wherewithal to disregard a student's ability to pay when making admissions decisions. According to Donald E. Heller, an associate professor and senior research associate at Pennsylvania State University, only about three dozen colleges and universities now commit themselves to meet every admitted student's need. "So it's safe to conclude that all other institutions, to one extent or another, take financial need into account when deciding which students to admit," says Heller.

Will your children be affected? It depends on the strength of their credentials, Heller says. Most top candidates will be accepted regardless of need, and may even be awarded merit scholarships. But other students may be judged in part on the basis of how much they will cost the school. "When admissions staffs get down to those last pools of applicants, very often they will not admit students who need financial aid if they know the school can't meet that need," says Heller. "At that point, candidates who can pay their own way have an advantage."

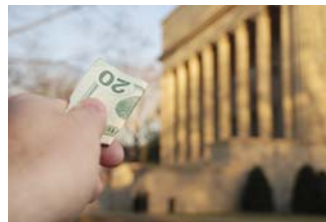
That's not the way things generally worked during the 1970s and early 1980s, when most colleges at least aspired to need-blind admissions policies. By the mid-'80s, however, most admissions offices had adopted a more pragmatic business model often referred to as enrollment management. The bottom line for the admissions staff was simple: Fill the

A Mixed Record On U.S. Government Bailouts

The final cost of the U.S. government's still-evolving rescue plan for the nation's financial institutions may be impossible to tally. Beyond parceling out the $700 billion of the Troubled Asset Relief Program (TARP), the U.S. Treasury Department and the Federal Reserve are providing wide-ranging financing, loan guarantees, and foreclosure relief for homeowners. But whatever the price tag, and however much or little of its investment the government eventually recoups, the plan will ultimately be judged on whether it accomplished what it set out to do—avoid massive bank failures, thaw frozen credit markets, stabilize home prices, and just generally pull the nation out of its economic tailspin.

Those are ambitious goals, but this is hardly the first time the government has attempted to save threatened industries or companies. ProPublica, a public interest news organization, recently compiled a list of 15 U.S. bailouts that begins with the 1970 rescue of the Penn Central Railroad and continues through today's multiple efforts. Though some initiatives managed to stabilize important American institutions, the overall record has been decidedly mixed.

Typically, the government steps in only after its hand has been forced. In the case of Penn Central, for example, the railroad was nearly bankrupt when it asked for help from the Federal Reserve, arguing that support was vital because the railroad transported goods essential for national defense. But Congress balked and Penn Central, which had placed large bets on real estate and other non-railroad investments, declared bankruptcy to avoid repaying debts owed to numerous commercial banks. Fearing a chain reaction of bank failures, the Fed in 1971 provided almost $700 million in loan guarantees. In 1976, the U.S. merged Penn Central with five other rail carriers into Conrail, a national freight railroad company, and later sold the company to private investors. All told, the government spent almost $20 billion to keep Conrail running, then recouped about $4 billion on the sale.



Other transportation industries have needed their own bailouts. Defense contractor Lockheed, which made military aircraft, wanted to produce commercial jets as well, but problems with its first passenger plane left the company in dire financial straits. In August 1971, Congress passed the Emergency Loan Guarantee Act, and to save 60,000 jobs in California and avoid a threat to national defense, the government guaranteed $250 million in financing (more than $1.3 billion in 2008 dollars). Lockheed repaid the loans by 1976, according to ProPublica, and the U.S. actually made money on the deal, receiving $112 million in loan fees.

New York City and Chrysler Corp., in 1975 and 1980, respectively, also asked for and received federal bailouts. President Gerald Ford at first refused to help the insolvent city, but once New York had made efforts to save itself, he signed legislation that provided billions of dollars in loans and loan guarantees, all of which was eventually repaid. In 1979, Chrysler lost $1.1 billion and was on the verge of bankruptcy. Once again, Congress acted, and $1.5 billion in government loans, matched by commercial lending, saved the company. According to ProPublica, the U.S. netted more than $600 million on its bailout investments.

Several past bailouts involved financial institutions, including Franklin National Bank in 1974 and Continental Illinois National Bank and Trust Company in 1984. But by far the biggest previous rescue involved the savings and loan industry in 1989. In what was then the greatest collapse of financial companies since the Great Depression, more than 1,000 S&Ls failed. The Resolution Trust Corporation, formed as part of legislation passed in 1989, took over failed institutions and sold assets at an ultimate cost to taxpayers of $293 billion, according to ProPublica.

Current government efforts dwarf anything it has done before. Already, hundreds of billions of dollars have been spent to arrange for the sale of Bear Stearns, guarantee the solvency of Fannie Mae and Freddie Mac, rescue American International Group, Citigroup, and automakers General Motors and Chrysler, and inject capital into banks through TARP. It may take years to judge the success or failure—and add up the total cost—of this latest, greatest government bailout. ●

class but don't exceed the financial aid budget.

Today, enrollment management is firmly entrenched at most schools. Moreover, with economics affecting alumni giving and pressure being put on endowment earnings, a student's financial situation plays an increasingly critical role in the admissions process. As a result, strategies for maximizing a student's apparent need by putting assets in parents' names and taking advantage of aid formulas that require students to spend a larger proportion of their own savings could have undesirable consequences. And not saving for college at all, while counting on financial aid to bear the brunt of school costs, could prevent your children from getting into the colleges of their choice.

The safest approach to college funding is to plan to pay as much as possible yourself. Positioning your assets to qualify for financial aid or counting on the availability of loans could backfire with the admissions office and your kids. ●

A Better Estate Plan For Business Owners

If you own a small business, you're likely working around the clock to build your company. But you still need to find time for estate planning. Despite recent tax-law changes, federal estate tax remains a prime concern for successful business owners. For someone who dies in 2009, the federal estate exemption can shield from tax up to $3.5 million in assets going to non-spouse beneficiaries (up from $2 million for 2008). But any excess is taxed at the top 45% estate tax rate.

While the estate tax is scheduled to vanish in 2010, it is likely that Congress will not let that happen, as current legislation proposes retaining the current $3.5 million exemption, with a maximum tax of 45 percent. And whereas heirs currently can "step up" the tax basis of assets for capital gains purposes—calculating subsequent gains or losses based on the assets' value on the date of death of the person who bequeathed them—that provision is due to change in 2010, at which point there will be a limited step up in basis.

However, estate tax minimization is only one aspect of estate planning. Financial planners offer many other services to help clients meet their estate planning goals. Here are four estate-planning tools a business owner might put to good use.

Buy-sell agreement. This legal document can establish the value of your business for estate tax purposes while ensuring there will be cash for your family upon your death. A buy-sell agreement spells out arrangements for purchasing shares from a deceased co-owner or partner. Typically, the buyout is funded with life insurance on the owners or partners.

Section 303 stock redemption. Under Section 303 of the tax code, your family can remove cash from the business with little or no tax liability by redeeming company stock. This special provision may provide funds to pay funeral costs, estate and administrative expenses, and federal and state estate taxes. To be eligible, the value of the company stock held by the estate must exceed 35% of the estate's total value.

GRATs. With a grantor retained annuity trust (GRAT), you transfer company stock to a trust that pays out annual income for a specific term, with the assets ultimately going to the beneficiaries you designate. This planning technique enables you to freeze the current value of the business in your estate. The amount of associated gift tax depends on the value of the stock transferred, the term of the GRAT, and the Section 7520 interest rate at the time of the transfer.

Installment payments. Another tax code provision allows your executor to spread out estate tax payments over 15 years. Among other requirements, the business interest again must comprise more than 35% of your overall estate.

Of course, every business owner's situation is different. One important thing to remember is to always ensure liquidity or these techniques will not be successful. Therefore, adequate life insurance is essential. We can work with you to discuss strategies to best address your unique planning needs. ●

Obama 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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