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THE VIEW

"It is a good thing that we do not get as much government as we pay for." - Will Rogers

Estate Tax ... A Ticking Time Bomb

One of the provisions in the Economic Growth & Tax Relief Reconciliation Act of 2001, that President Bush signed into law, allowed for the estate tax unified credit exclusion to be increased in steps from $1 million in 2002 to $3.5 million in 2009. In 2010 the estate tax would disappear altogether. This legislation came with a sunset provision, though, meaning that the law would expire at the end of 2010 and the "old rules" would begin to apply again in 2011. It had generally been assumed after passage of the bill in 2001 that Congress would at sometime amend the estate tax law before the end of 2009 and allow for some of the enacted provisions to continue, like leaving the unified tax exclusion at a higher level than $1 million. But, here we are halfway through 2010 and no revised estate tax law legislation appears on the horizon.

A quick explanation of the estate tax is warranted here. Though space does not permit an entire treatise on the subject, suffice it to say that the estate tax is a federal tax that is generally assessed at a person's death (or at the death of the second to die for a married couple). The overall estate is valued and any amount over the unified credit is subject to tax (the actual definition is much more technical). For many, the estate tax rate is between 40 and 50%. Without any "change" to the current law the "exclusion amount" for estates reduces back down to $1,000,000 in 2011 with the highest tax rate at 55%.

Here is a very over-simplified example using the "old" rules which come back into play in 2011. Say a couple has amassed a home, rental property, various stocks and bonds and has some life insurance. The husband dies before his wife and a year later she passes away. Assume the value of all of these assets at her death is $2,500,000. They each have a unified tax credit of $1 million, so together $2 million of their estate avoids the estate tax. The remaining $500,000 is subject to the estate tax at approx. 50% ($250,000). The decedents' estate would have nine months from the date of the wife's passing to pay the tax to the federal government. Depending on the state you live in there could be additional state inheritance taxes.

As you can see, the unified tax credit in 2009 of $3.5 million would have allowed a married couple to avoid taxation on an estate up to $7 million. Even with high property values in California, many of our clients would not have been affected by the estate tax if the 2009 credit was available. A new mosaic, unfortunately, is emerging. With large federal government deficits that require funding (not to mention all the various state and local deficits) , a Congress and administration that currently appears ready to further tax successful and wealthy Americans and who have inferred their intent to redistribute wealth, all point to a picture that is disconcerting both to us and our clients. A high proportion of our clients could potentially be negatively affected if the 2001 estate tax legislation is not amended as was initially hoped.

Two immediate strategies that reduce future estate taxes and are simple to execute are gifting and charitable giving. When gifting, an individual can give $13,000 per year (current level) without incurring gift taxes. For example, a married couple that has 2 sons can each gift their sons $13,000 apiece for a total of $52,000 each year. In the case of Charitable giving, an estate can be reduced yearly by accelerating future gifts or by more sophisticated strategies that employ trusts to accomplish similar goals.

We will continue to monitor political developments and advise 'at risk' clients on ways to reduce the potential costs we see to their overall legacy assets intended for children, grandchildren, charities, etc. .

Federal Reserve Continues to Offer Candy to Unsuspecting Children …

The Federal Reserve continues to target the Federal Funds Rate at 0-.25%. This purportedly has the effect of making borrowing and investing for America's corporations cheaper, thus spurring investment. In the past, this certainly has worked. In the recession of this past year it seems the policy is also having the desired, albeit, muted affect. But what about the lack of lending by the banks? Or the lost income for fixed income investors that rely on that income for their day-to-day living needs? They are being forced to seek more aggressive and risky investments (against their true will) so as to meet their income or lifestyle objectives. This also has the undesirable consequence of forcing money into fundamentally unsound investments that would otherwise not warrant such investment. It artificially elevates asset prices to levels that are not sustainable with a more normalized Fed Funds Rate.

The Federal Reserve's arguments with regard to maintaining an extremely accommodative stance are well-founded. The unintended consequences of this policy, however, need to be seriously considered by investors before they take the Fed's candy. The Federal Reserve would love to be able to hike the rate up to at least 1% to give themselves some room to maneuver. The fact that they haven't should be another warning to investors. If the economy falters in the second half of this year the Federal Reserve will have very few options available to them short of bringing back the liquidity programs they initiated starting in 2008 and have largely exited as of this writing. Investors should be aware of these ramifications before they seek higher yielding investments as there may be a price to pay for doing so.

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