Financial Security by Design

Planning and Compliance for Individuals, Trusts and Estates

June 25, 2002

Dear Customers and Friends,

Pension Conformity. California has adopted the federal enhancements to the pension and education savings programs. While I and other advocates raised hypothetical concerns with our state legislators, the unions representing state employees were more effective because they were able to cite specific situations where retirees, on a daily basis, were being denied rollovers and other benefits. Thank you, unions.

The California legislation conformed to more than just tax advantaged savings programs. A downside of conformity is that we will need to pay at least 90% of our California tax through estimates this year, up from 80% last year.

Market Forecast. Paying more of our estimated taxes currently would have been a good investment strategy recently. Last Thanksgiving, I stepped out of character and ventured a market prediction. "In summary, the weight of the evidence is that the worst of the market decline is behind us and it will be time, in the next couple of weeks, to increase stock allocations or to become less fearful if you are a buy-and-hold investor. " I was wrong and the market is about back to its September lows.

My failure illustrates the challenge facing active managers. Active managers could have shined over the past couple of years simply by moving to cash and yet "... less than half of the nation's more than 600 large-cap core, value and growth stock funds have beaten the index over the past three years, according to data from New York-based fund-tracker Lipper Inc. It's a trend that stretches back some time. Less than a quarter of large-cap stock funds have topped the index over the past ten and fifteen years[1]."

Those investors who are making money in this market have done so by switching to yesterday's laggards. Value investing is back in vogue after years on the outside. Real estate and small cap stocks, considered dogs of a couple of years ago, are up smartly. European currencies are up relative to the dollar and this increase may trigger gains in the international indices.

[1] "If Index Funds Have a Cold, Active Pros Have Pneumonia" by Ian McDonald, *The Wall Street Journal*, June 18, 2002.

Certified Financial Planner™ - Enrolled Agent - Registered Investment Advisor
852 Acampo Drive, Lafayette, CA 94549-5040
(925) 299 - 0472 FAX (925) 299 - 0473 lingane@post.harvard.edu www.lingane.com/tax

These observations reinforce my view that the only realistic investment strategy for most of us is to own a diversified portfolio with relatively stable allocations to U.S. and international stocks, real estate and fixed income securities.

Speaking of fixed income, interest rates have fallen because of the Federal Reserve and because some investors, fearing market losses, have moved from stocks to bonds. The yield on 10-year Treasury bonds is a bit under 5%. CDs pay a bit more but the yields are comparable after deducting California income tax. The yield on Inflation Protection Treasury Securities (TIPS) has fallen to 3% plus inflation but TIPS continue to provide a yield premium unless you expect future inflation to remain low by historical standards.

The decline in interest rates could be good news for the stock market since there is empirical evidence that, when bond yields are low as currently, the market is to be able to sustain a higher price earning ratio. Using this model[2], Yardeni (Chief Investment Strategist with Prudential Securities) suggests that the current stock market is slightly undervalued.

The market decline has brought price earnings ratios more in line with historical values. This would bode well for future prices except that we are constantly learning of firms which used gimmicks to boast earnings. It seems clear that adopting more conservative accounting methods will reduce future earnings. Slower earnings growth, even though the slowdown is induced by desirable accounting changes, will probably be a drag on future stock prices.

More on Active Management. When Louis Rukeyser was fired a couple of months ago, he recreated his show on CNBC in the identical, Friday time slot. Lou seems to have learned something from his dismissal. His panelists are getting more air time and his special guests are the biggest names in the business. Peter Lynch, for example, is scheduled this week

Investors apparently love market tips. At least Lou and the rest of the financial media work hard to elicit specific recommendations from their guests. However, acting on such tips is a silly investment strategy for lots of reasons.

First, the tipster could easily be wrong. *The Wall Street Journal* has pitted professionals against the laws of chance for the past dozen years and the professionals beat the throw of a dart only 60% of the time. There is also the disappointing performance of active managers discussed above.

Second, active management means a percent or more in extra costs. And a couple of percent in extra taxes unless you trade in a pension account. Since a

---

[2] To find Yardeni's commentaries, go to www.prudential.com and enter "yardeni" in the search window.

This correlation is called the "Federal Reserve's Stock Valuation Model" because it was a Fed analyst who first reported the correlation. However, the Federal Reserve does not endorse this model. See also www.gimlink.com/Free_Reports/GIMReport12-98.pdf. For a less positive view of this correlation, see www.valueinvestor.net/stocksvsbonds.htm or www.dolancap.com/research/primer.htm.

couple of percent is about the margin of victory for those exceptional managers who have beaten the averages over long periods, there is not a lot left for you even if you receive exceptional advice or have selected an exceptional manager.

Your opportunity to profit from a media tip is also reduced by the almost instantaneous increase in price when a stock is recommended[3].

My point is that active management provides only a small gain, at best, after taxes and expenses and there is a huge risk of failure.

A big problem with a passive strategy is controlling our natural instinct to sell when the market is going down. A "rainy day" fund reduces our emotional response to a market decline by insuring that there is always enough in stable investments to pay the mortgage and your children's college bills.

Updating Your Estate Plan. Last year's changes to the federal estate tax were pretty significant. There is more clarity about how to incorporate pensions into an estate plan than there was even a few years ago. And you are older and wiser and hopefully richer than when you created your present estate plan.

For all of these reasons, you probably should review how your assets will be distributed when you die. Not how you think that your assets will be distributed but how they will be distributed under the terms of your will or trust. If you don't understand these documents, get competent advice. If your documents no longer do what you want, ask your attorney for changes.

We create trusts to control the ultimate disposition of our assets, to provide for a younger or disabled heir or to claim the marital deduction when the surviving spouse is not a U.S. citizen.

Married couples also use trusts is to save estate tax at the death of the surviving spouse. For example, a trust can reduce the valuation of a business or personal residence at the second death[4]. More commonly, a married couple will create a "bypass trust." The assets in this trust are not considered at the second death because the surviving spouse can only access the trust's assets to satisfy their needs; he or she is denied access to satisfy their wants.

Trusts can be a hassle and they can require a separate income tax return. Bypass trusts become less attractive when they must be funded with a

---

[3] From www.bigcharts.com yesterday morning "10:40AM Digital River (DRIV) is gaining 51 cents, or 8.1 percent, to $6.81, after Prudential raised its rating on the e-commerce outsourcing firm's stock to "buy" from "hold" and set a price target of $10." Prudential's report had hit the news wires at 8:25 AM.

[4] This principle was established in *Mellinger,* AOD 1999-006. A business was valued at a discount because part was owned by the surviving spouse and part by a QTIP trust. A personal residence split between the surviving spouse and a bypass trust should also create a discount. However, a trust controlled by the surviving spouse will not create a discount; see *Estate of Fantana (2002)*, 118 TC 16.

A valuation discount reduces the step-up in basis at the second death. It is therefore not attractive unless there is likely to be estate tax at the second death.

personal residence since there will generally be income tax if the property is sold and no step-up in basis at the second death.

There are also issues with a residence if the bypass trust has no liquid assets. Can the surviving spouse claim the real estate tax deduction if they pay the tax? If the surviving spouse pays the upkeep, does this mean that part of the value of the bypass trust has to be included in his or her estate?

Couples have been willing to live with the downsides of a bypass trust in order to save estate tax. However, the increases in the exemption amount[5] may have eliminated your potential for savings.

Consider a couple who are worth a million dollars. Since there won't be any tax at the second death if everything passes directly to the surviving spouse, a bypass trust no longer provides any tax savings.

If the couple are worth two million dollars, there might be several hundred thousand dollars in estate tax at the second death without a bypass trust. But, if the surviving spouse lives until 2006 when the exemption amount is two million dollars, a bypass trust might not produce any savings.

If you find that the bypass trust is no longer needed, your documents could be revised to eliminate this trust. However, it is probably more prudent to make the bypass trust optional. Your attorney will know how this can be done.

The increase in the exemption amount could impoverish the surviving spouse. If most of a couple's assets are owned by the first spouse to die, very little might flow to the surviving spouse if the document funds the bypass trust to the exemption amount, with the balance to the surviving spouse, and the surviving spouse is not the beneficiary of the bypass trust.

This scenario is unlikely in California since the surviving spouse generally gets half of the community property even with the increased exemption amounts. But even California couples should review their dispositive provisions if most of their assets are the separate property of one or the other spouse.

Final Regulations Governing Distributions from IRAs and Pensions. Distributions before death are generally based on the joint lives of the owner and a hypothetical beneficiary who is ten years younger. When the beneficiary is a much younger spouse, the distributions consider on the actual age of the spouse. Revised actuarial tables increase life expectancies by about a year. And, as always with tax changes, the devil is in the details.

---

[5] $1MM currently, $2MM from 2006, $3.5MM in 2009, unlimited in 2010 and $1MM from 2011.

Repeal of the estate tax is unlikely because this decision is so enmeshed in politics and because repeal represents a substantial amount of lost revenue. My prediction is that the ultimate decision will be to extend the estate tax provisions as they will exist in 2009, the year before the scheduled repeal, meaning that the exemption amount will stabilize at $3.5 million or thereabouts.

The final regulations need not be used until next year but most retirees will find it is advantageous to begin using them immediately. Give me a call if you need assistance recalculating your minimum distribution.

Leaving Pension Assets. If your heirs are unlikely to spend all of your money all at once, planning can increase several fold the value that your heirs receive from a pension. For example, converting to a Roth IRA increases the value that your heirs receive because conversion shelters more dollars from income tax and stops the shrinkage caused by minimum required distributions.

It is also important that your heirs be able to take distributions over a long period. With younger heirs, the slowest distributions result when they take distributions over their lifetimes. This is only possible if they receive the IRA or pension directly from the owner without a trust or other beneficiary in between.

Thus the optimum pension strategy for a married couple is often to leave the decedent's pension to the surviving spouse. This provides for their needs and they will be treated as the owner for purposes of stretching out distributions to the ultimate heirs. But what do we do when the pension is needed to fund a bypass trust and leaving it to the spouse risks estate tax?

- Name the surviving spouse as the pension beneficiary and the bypass trust as the contingent beneficiary should the spouse say "No, thank you."

  If the surviving spouse disclaims some or all of the pension, there will generally be faster distributions and less tax deferral for your heirs. Therefore, be sure to calculate whether the potential estate tax savings from funding the bypass trust exceeds the value of the decreased tax deferral.

  A disclaimer doesn't provide any estate tax savings if the pension is owned by one spouse and the poor spouse dies first. A disclaimer will also fail if the surviving spouse is unwilling or unable to act or does not act quickly enough. But most importantly, your pension provider might not accept a beneficiary designation which includes a disclaimer[6].

- Name the couple's joint living trust as primary beneficiary[7].

  If authorized by state law[8], the trustee can allocate specific community property assets to the decedent's share rather than basing the decedent's share on one half of each community asset. For example, the trustee could allocate the decedent's community property interest in all pensions to the

---

[6] I praised Vanguard a couple of years ago for the sophistication of their beneficiary designation options. Unfortunately, Vanguard is no longer accepting disclaimer designations.

[7] For more on this strategy see, Natalie Choate's "Life and Death Planning for Retirement Benefits," 4th Ed., 2002. This book can be purchased at www.ataxplan.com.

[8] There are income tax issues if the trustee makes a non pro rata division without the backing of local law.

surviving spouse and compensate by allocating securities of equivalent value, which are also community property, to the bypass trust.

This strategy allows the bypass trust to be funded with non pension assets but we still need to find a way to roll the pension over to a pension in the name of the surviving spouse. The IRS has issued private letter rulings that suggest that this is permitted so long as the surviving spouse is trustee and has exclusive control over the pension allocation.

Private rulings are indicative of the IRS's thinking and they do not bind the IRS except with respect to the person who requests the ruling. The obvious risk of this strategy is that the IRS might change its mind about rolling the pension out to the surviving spouse. Other risks are that the surviving spouse might be incompetent and unable to effect the rollover or that the poor spouse might die first. But the biggest drawback is that your pension provider may balk at the required transfers[9].

- A married couple can execute an agreement whereby the survivor's share of the community property is deemed to include the community pensions and the decedent's share is deemed to include other assets of equivalent value. This strategy[10] removes the threats that the surviving spouse might not be able to act or that the IRS might change its mind or that the wrong spouse might die first. But the biggest advantage of a community property agreement is that you don't need the cooperation of your pension provider.

Compensation. Merrill Lynch's recent decision to pay a big fine and to change how it pays Merrill Lynch analysts highlights the corrosive influence that financial incentives can have on an adviser's impartiality.

To protect your right to impartial advice, I have chosen to forgo commissions and other indirect forms of compensation. My customers pay me directly.

For more discussion of these topics, check out my website. If you can't find want you need, or have further questions, please call.

Sincerely,

Peter James Lingane

---

[9] Discussions with a Fidelity retirement planning specialist suggest that Fidelity will balk, for example.

[10] For more on these, see Steve Trytten's "How To Draft The Estate Planning Documents To Effectively Handle Retirement Plan Distributions" at http://www.iracaddie.com/SCTEPMarch2002a.pdf.

There are no income tax issues in California since aggregate agreements are authorized by state law.

Community property agreements are evolving law. This approach will not work for a employer pension unless the spouses waive certain spousal rights that they have under federal ERISA legislation. Trytten also suggests that it is prudent to waive spousal rights even with IRAs and to include certain other statements to sidestep potential conflicts with California law.