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# Financial Briefs

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## Dealing with Asset Basis

Deciding whether you should give a significant asset to an heir during your life or after your death has typically involved weighing potential estate tax costs against capital gains taxes that would be due when the asset is sold.

You can make annual gifts, up to \$12,000 in 2006 (\$24,000 if the gift is split with your spouse), to any number of individuals without paying federal gift taxes. There is also a lifetime gift exemption of \$1,000,000 (\$2,000,000 if the gift is split with your spouse). The basis of any gift made during your lifetime equals your basis plus any gift taxes paid on the gift.

The estate tax exclusion increased from \$1,500,000 in 2005 to \$2,000,000 in 2006 and will increase again to \$3,500,000 in 2009. The estate tax rate is 46% in 2006 and will drop to 45% in 2007. The basis of any asset distributed to heirs after your death is stepped up to fair market value on the date of your death. The significant increase in the exclusion amount means that assets with fairly significant values can be transferred to heirs without paying estate taxes, while still stepping the bases up to fair market value. However, keep in mind that the estate tax will be repealed in 2010, with special rules in effect for basis adjustments for that year. In 2011, the estate tax will be reinstated based on 2001 tax laws, unless further legislation is passed.

Thus, when making gifts, you have historically needed to evaluate whether it was better to make the gift after death so your estate will pay estate taxes or during your lifetime so your heirs will pay capital gains taxes when the asset is sold.

Now that the estate tax exclusion amount is so high (\$2,000,000 in 2006), many individuals do not need to focus on estate taxes. Instead, gifts should be made in a manner that will reduce overall income and

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## Estate Planning for Your Retirement Accounts

For many people, retirement accounts, including 401(k) plans and individual retirement accounts (IRAs), are their most significant assets. While you may think you'll need every bit of money in those accounts for your retirement, what would happen if you die at an early age? You should include them in your estate plan so heirs inherit them with minimum estate and income tax effects. Some strategies to consider include:

- **Review your beneficiary designations.** These assets are distributed based on beneficiary designations, not your will or other estate planning documents. Thus, you should name primary as well as contingent beneficiaries. Make sure you understand how your assets will be distributed if a primary beneficiary dies before you do. For instance, if your primary beneficiaries are your children and one child dies before you, do you want that child's share to go to that child's children or to your remaining children? Review your beneficia-

ry designations after major life changes, such as marriage, divorce, or the birth of a child.

- **Consider rolling your 401(k) plan assets over to an IRA.** Your heirs have more flexibility when making withdrawals from an IRA. With a 401(k) plan, heirs typically must withdraw all funds within five years, while withdrawals can be made over their life expectancy with an IRA. As long as the rollover is handled properly, there are no income tax ramifications of the rollover.
- **Split an IRA when there are multiple beneficiaries.** When there is more than one non-spousal beneficiary for an inherited IRA, distributions must be taken over the oldest beneficiary's life expectancy. By splitting the IRA into separate accounts (no later than December 31 of the year following the IRA owner's death), each beneficiary can take distributions over his/her life expectancy. Separating accounts is especially important when one of

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## Retirement Accounts

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the beneficiaries is not an individual or qualifying trust, such as a charitable organization. If you die before required distributions begin at age 70 1/2, the entire balance must be paid out in five years. If you die after required distributions begin, the balance must be paid out over your remaining life expectancy. When the account is split, each individual beneficiary can take distributions over his/her life expectancy.

- **Make sure your spouse understands the rules for inheriting your IRA.** Your spouse should be careful not to roll the balance over to a spousal IRA too quickly. Once the balance is rolled over, some planning opportunities are lost. For instance, spouses under age 59 1/2 can make withdrawals from the original IRA without paying the 10% federal income tax penalty. Once the account is rolled over, withdrawals before age 59 1/2 would result in a 10% federal income tax penalty. Also, spouses who are older than the original owner can delay distributions by retaining the IRA. The surviving spouse does not have to take distributions until the deceased spouse would have attained age 70 1/2, even if the surviving spouse is past that age. The spouse may want to disclaim a portion of the IRA, which must be done within nine months of the original owner's death. If the account is rolled over, that disclaimer can't be made. Thus, it is usually best for the surviving spouse to determine his/her financial needs before rolling over the IRA balance.
- **Consider rolling your traditional IRA balances over to a Roth IRA.** While you must meet income eligibility requirements to do so and pay income taxes on the taxable amount of the conversion, those taxes can be paid with funds outside the IRA. That preserves the IRA's value and re-

## A Look at Generation-Skipping Taxes

When leaving assets to children who have substantial estates of their own, the likely result is that estate taxes will be paid when the children inherit the assets and then again when those assets pass to the grandchildren. In those situations, leaving the assets directly to the grandchildren can help minimize estate taxes.

However, to limit these types of transfers, the government imposes a generation-skipping transfer (GST) tax on large distributions. The GST tax applies when transfers are made to a "skip person," defined as someone who is two or more generations younger than the person transferring the property. The GST tax is equal to the maximum federal estate tax rate and is applied in addition to any gift or estate taxes due. The GST tax applies to direct gifts, income from trusts, and distributions after termination, whether the distribution is made during the transferor's life or at death.

However, you can transfer assets with a value up to the GST exemption amount before the GST tax must be paid. The GST exemption amount follows the estate tax exemption schedule and tax rate:

Exemption		
Year	Amount	Tax Rate
2006	\$2,000,000	46%
2007-2008	2,000,000	45
2009	3,500,000	45
2010	N/A	Repealed

Then, due to the sunset provisions of the 2001 Tax Act, the GST exemption and tax rate will return to those in effect in 2001. Proper

planning would allow a married couple to transfer twice the amounts listed above. In addition, your annual tax-free gifts (up to \$12,000 in 2006 or \$24,000 if the gift is split with your spouse) are not subject to the GST tax.

To maximize distributions to grandchildren while minimizing taxes, consider the following:

- **Take advantage of annual tax-free gifts.** Over a period of years, a substantial amount of assets can be transferred. For instance, if you and your spouse make annual gifts of \$24,000 to each of five grandchildren for 10 years, you would remove \$1,200,000 from your estate without paying any taxes.
- **Consider setting up a trust for your grandchildren during your lifetime.** You can use your GST exemption now, so any future growth in the assets' value will accrue outside your estate and not be subject to estate or GST taxes.
- **Review funding amounts for distributions made after your death.** Many estate planning documents specify that trusts should be funded with assets equal to the GST tax exemption amount. With the exemption amount increasing significantly between now and 2009, that may result in too much of your estate going to your grandchildren. You may want to change your estate planning documents to put a cap on the amount that

duces your taxable estate. Then, your heirs will receive qualified distributions free from income taxes, including any future appreciation on the balance.

- **Teach your heirs the benefits of stretching out withdrawals from inherited IRAs.** After an IRA is inherited, a traditional deductible IRA still retains its tax-deferred

growth and a Roth IRA retains its tax-free growth. Your heirs should extend this growth for as long as possible. Make sure to stress to heirs the importance of taking withdrawals as slowly as possible.

If you'd like to discuss the estate planning aspects of your retirement accounts, please call. ■■■

## Asset Basis

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capital gains taxes for the family. Some strategies to consider that may help accomplish this objective include:

- **Transfer low-basis assets after death.** When heirs receive an asset that has increased significantly in value after your death, its basis is stepped up to market value. They retain your basis when it is received during your lifetime, so significant capital gains taxes may be due when the asset is sold. However, if you plan to sell the asset in the near future, you should consider the tax impact if you own the asset or your heirs own the asset. Especially if you are going to use the proceeds for your heirs' benefit anyway, there may be a lower capital gains tax bill if your heirs sell the asset. Capital gains taxes are currently 15%, but taxpayers in the 10% or 15% tax bracket only pay 5%.
- **Consider using an estate defective trust (EDT) to transfer significant low-basis assets.** Once the asset is placed in trust, any income from the asset is allocated to the trust or the trust beneficiaries, who will typically be in a lower tax bracket. However, the asset is still considered part of your estate, so heirs will receive a step-up in basis after your death.
- **Reevaluate buy-sell agreements for businesses.** Often, buy-sell agreements are funded with life insurance. If one owner dies, the other owners use the life insurance proceeds to purchase the deceased owner's shares. If the life insurance is owned by the company, the proceeds are paid to the company and the remaining owners do not receive a step-up in basis. If each owner owns life insurance on the other owners, the proceeds will be paid to each

## Distributing Assets to Adult Children

When your children were young, your primary concern was probably how to provide for them in the event you and your spouse died. Even though they may now be grown, your children are probably still the center of your estate plan. Just because they are adults doesn't mean that you have to leave their entire inheritance to them outright. Consider these factors first:

- **Do you want to distribute your estate gradually?** If substantial assets are involved, you may want to set up trusts to distribute your assets gradually, such as in thirds when each child reaches age 25, 30, and 35. You can always give the trustee power to make early distributions for items like paying for college, starting a business, or purchasing a home.
- **Have you selected a trustee carefully?** If trusts are involved, you want a trustee who is impartial and will deal fairly with all your children. Think twice before naming one of your children as trustee. One sibling in a position to decide what happens to another sibling's inheritance can cause disagreements between siblings.
- **Have you thought about the consequences of a child divorcing?** You probably don't want

some of your assets distributed to an ex-daughter-in-law or ex-son-in-law, so special provisions may need to be added to trusts.

- **Have you considered how assets will be distributed among children?** Perhaps one child is better off financially than your other children. Do you divide your estate equally or give less to the financially well-off child? Children often feel a right to an equal share of their parents' estate, even if they have a substantial estate of their own. If you decide to make unequal distributions, be sure to explain why.
- **Do you need to make special distributions to even out inheritances?** Perhaps you have paid all college costs for some children, while other children have not attended college yet. You may want to ensure that all children receive a college education, and then distribute the rest of your estate equally among your children.
- **Should you coordinate your estate plan with your children's estate plans?** If your children have substantial estates of their own, it may not make sense to leave additional assets to them. They may prefer those assets go directly to their children, helping to minimize family estate

remaining owner. Those owners can then use the proceeds to purchase shares from the company at fair market value, in essence receiving a step-up in basis.

- **Review discounting techniques carefully.** Many estate planning strategies have involved the use of discounts to reduce the fair market value of the transferred assets. For instance, individuals who transfer noncontrolling in-

terests in businesses, farms, real estate, and other assets may be able to assign a minority interest discount to the gift's value. Now, as long as the gift won't result in the payment of gift or estate taxes, your primary goal will be to increase the basis as much as possible.

Please call if you'd like to discuss asset basis and your estate plan in more detail. ■■■

## Business Data



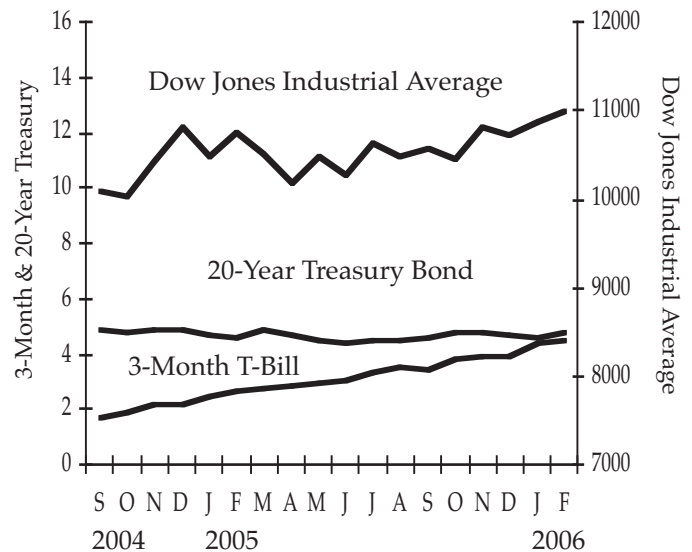
Indicator	Month-end				
	Dec-05	Jan-06	Feb-06	Dec-04	Feb-05
Prime rate	7.25	7.50	7.50	5.25	5.50
3-month T-bill yield	3.91	4.38	4.51	2.23	2.72
10-year T-note yield	4.45	4.36	4.59	4.21	4.16
20-year T-bond yield	4.71	4.59	4.76	4.84	4.61
Dow Jones Corp.	5.30	6.18	5.56	4.97	5.01
GDP (adj. annual rate)#	+3.30	+4.10	+1.10	+3.80	+3.80

Indicator	Month-end			% Change	
	Dec-05	Jan-06	Feb-06	YTD	12-Mon
Dow Jones Industrials	10717.50	10864.86	10993.41	2.6%	2.1%
Standard & Poor's 500	1248.29	1280.08	1280.66	2.6%	6.4%
Nasdaq Composite	2205.32	2305.82	2281.39	3.4%	11.2%
Gold	516.00	568.75	556.00	7.8%	27.7%
Money supply M2 (bil.)@	6652.00	6680.40	6743.00	0.9%	4.5%
Consumer price index@	197.60	196.80	198.30	0.8%	3.4%
Index of leading ind.@	138.80	138.50	140.10	1.2%	21.2%

# — 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan

Sources: *Barron's*, *Wall Street Journal*

## 18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield September 2004 to February 2006



## News and Announcements

### Help Your Friends

We have worked together to create a financial strategy and investment portfolio that has put you on the path toward your investment goals and objectives. During this time, I am sure you realize the importance of professional financial advice when it comes to understanding different types of investments, asset allocation, and how the economic and political environment relates to your financial situation.

I enjoy helping to guide you through this complicated maze of financial information, and I value the faith and trust you place in me. My goal is to ensure you are pleased with the

work I do for you.

I also hope you will be so satisfied with my work that you will want your friends and relatives to benefit from my services as you have. So, if you have friends or relatives who you think could benefit from my services, please tell me about them. Please be assured that I will treat your referrals with the same degree of confidentiality and respect that you are accustomed to. I value you as a client and thank you for giving me the opportunity to help others to achieve their financial goals.

*Rick*

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