

Asset Strategies Monthly

November 2010

Federal Estate Tax Update--Inheriting Property in 2010



Currently, there is no estate or generation-skipping transfer (GST) tax for 2010, but both taxes are scheduled to be reinstated in 2011, with a \$1 million estate tax exemption, a GST tax exemption of about \$1,340,000, and a top rate of 55%. The federal gift tax, however, remains in effect for 2010, with a \$1 million lifetime exemption and a top rate of 35%. Of course, it's still possible that we'll see legislative action in the next few months. For example, Congress could extend 2009 rates and exemption amounts (the result would be a \$3.5 million exemption amount for both estate and GST taxes and a top rate of 45%). It's impossible to predict specific action, however, or whether any such action will be applied retroactively to 2010.

Current 2010 rules

While the joke may be that this is a good year to die, in reality, it's not that simple. True, there's no federal estate tax--at least for the moment--but the rules that now apply in 2010 change the way inherited property is taxed--in a way that's not always favorable. This means that some individuals who inherit property in 2010 may be in for a surprise when they sell the inherited assets. It's all because of a change in the way cost basis is calculated for property inherited as a result of a death.

New cost basis rules for 2010

What's cost basis? The cost basis of an asset is generally its purchase price, and it's used to calculate taxable gain (or loss) when the asset is sold. For example, if you own a share of stock, your cost basis is generally the purchase price plus any costs incurred in the purchase (e.g., any commissions). With real property, your cost basis is increased if you make capital improvements.

Prior to 2010, the cost basis of any asset you inherited was generally "stepped up"

(or "stepped down") to what the asset was worth (its fair market value) on the day that the person who left you the property passed away. So, for example, if you inherited a piece of property worth \$100,000, that property would generally have a basis of \$100,000, even if the person who passed away had purchased the property for \$10,000. If you sold the property years later for \$115,000, any taxes due would be based on \$15,000 gain (\$115,000 minus \$100,000).

If you inherit property as a result of a death in 2010, however, this step-up rule doesn't apply. Instead, your basis in the inherited property is the lower of the property's fair market value as of the date of death or the deceased owner's cost basis. In the example above, that means that your basis in the property would be \$10,000, resulting in a \$105,000 gain if you sold it for \$115,000.

There are two very important exceptions. First, every estate gets a \$1.3 million increase in basis that can be allocated among assets (up to fair market value) by the executor of the estate, increased by unused built-in losses and loss carryovers. Second, there is generally an additional \$3 million increase in basis available for assets (also up to fair market value) passing to a surviving spouse, either outright or through a qualified terminable interest property (QTIP) trust (but only \$60,000 basis increase for nonresident alien decedents). This means the basis of assets in an estate with a surviving spouse as a beneficiary can potentially be increased up to \$4.3 million.

So, if the appreciation of assets in the estate is \$1.3 million or less (or \$4.3 million for a surviving spouse), then the basis of those assets can be increased to fair market value as of the date of death. This means if you inherit an asset in 2010 with its basis stepped up to fair market value, and you sell that asset for no more than its date-of-death fair market value, you'd realize no tax on the sale.

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Eight Financial Aid Myths



Do you have a child going off to college next fall? The federal government's financial aid application (the FAFSA, which stands for Free Application for

Federal Student Aid) is due as soon as possible after January 1, 2011. Here are some common myths about financial aid eligibility.

Myth #1: My child won't qualify for aid because our family makes too much money

Fact: While it's true that family income is the main factor that determines aid eligibility, it's not the only factor. The size of your family, the age of the older parent, and the number of kids you'll have in college at the same time all play into the equation. Even if you think your child won't qualify, you won't know for sure unless you apply, and it costs nothing to file the FAFSA. Besides, states and colleges typically require the FAFSA--in addition to any state and college specific forms--before they'll hand out their own aid.

Myth #2: The form is too hard to fill out

Fact: Years ago, the FAFSA was cumbersome to fill out. But ever since it went online at www.fafsa.ed.gov, it's easier than ever to submit. The online version has detailed instructions and takes you through step by step, asking only the questions that apply to you. If you need help, there are customer service representatives standing by with whom you can chat online. There is also a toll-free number you can call with questions: 1-800-4-FED-AID. All advice is free. Once you submit the form, it only takes about one week to process (compared to four to six weeks for a paper FAFSA).

Myth #3: If my child applies to a more expensive school, we'll get more aid

Fact: Not necessarily. The federal government determines your expected family contribution, or EFC, based on the income and asset information you provide on the FAFSA. Your EFC stays the same, no matter what school your child applies to. The difference between the cost of a particular college and your EFC is your child's financial need. The more expensive the college, the greater your child's financial need. But a greater financial need doesn't automatically translate into a bigger financial aid package. Colleges aren't obligated to meet 100% of your child's financial need (if they don't, you've been "gapped" in college parlance). Keep in mind, too, that there are annual borrowing limits on federal Stafford and Perkins Loans. Once your child has borrowed

the maximum amount for the year, his or her only chance for more aid has to come from grants, scholarships, and/or work-study jobs.

Myth #4: My child probably won't qualify for aid because of mediocre grades

Fact: The federal government does not take grades into account when determining aid eligibility. However, colleges will consider a strong academic record when awarding certain merit scholarships.

Myth #5: A minority student has a better chance of getting aid

Fact: The federal government does not consider race when determining aid eligibility. It doesn't collect this type of information.

Myth #6: I lost my job shortly after I filed the FAFSA, but there's nothing I can do about it now

Fact: If your financial circumstances change after you file the FAFSA, you can ask the financial aid officer at your child's school to revisit your aid package; the officer has the authority to make adjustments if there have been material changes to your family's income or assets. If you have a material change that you can support with documentation, politely request a "professional judgment review" in a letter addressed to the financial aid officer. There are no guarantees, but you won't know if you don't ask.

Myth #7: We own our home, so my child won't qualify for aid

Fact: The federal formula for determining aid does not take home equity into account (it also excludes retirement accounts, cash value life insurance, and annuities from consideration). However, colleges typically consider home equity when distributing their own institutional aid.

Myth #8: Our smart/athletic/talented child will likely get a scholarship to cover most, if not all, college costs

Fact: A vast majority of financial aid officers believe that parents overestimate the amount of scholarship and grant money their children will receive. While it's true that some students end up getting a free ride (or close to it), they're in the minority. Scholarships can fill the gap, but they probably shouldn't be relied on as the main funding source.

Child not in college yet?

If you have younger children, the federal government's FAFSA4caster tool is for you. It provides families with an early estimate of eligibility for federal student aid, and allows families to transfer all of their data to the online FAFSA once their child is ready to apply for aid. You can check it out at www.fafsa4caster.ed.gov.



What You Can Learn from a Mutual Fund Prospectus

When you're contemplating the purchase of a mutual fund, some of the factors you'll need to consider carefully before buying are its investment objectives, risks, costs, and expenses. Information about all of these can be found in the prospectus available from the fund. But traditional fund prospectuses can be too much of a good thing--lengthy documents with a lot of legal language that can make it difficult to find what you're looking for.

However, you now have a new option for comparing funds more efficiently. Over the last year or so, fund companies have been implementing new Securities and Exchange Commission regulations that are intended to ensure that investors can get key information in a more efficient, user-friendly format.

Shrinking the prospectus

Instead of mailing out a lengthy prospectus, fund companies may now choose to supply investors with a three- to four-page summary prospectus as long as the full prospectus is available electronically and includes the summary prospectus information as a section of the full prospectus. The summary prospectus must provide the following information in this precise order, which should make it easier to compare mutual funds.

Investment objectives and goals. This specifies the type of fund, such as a bond fund or balanced fund. It also indicates how the fund will try to earn a return--for example, by increasing the value of its assets (growth), providing periodic income, preserving capital, or some combination.

Costs, including a table of fees as well as a hypothetical example demonstrating the impact of those fees. The SEC specifically notes that it gave cost information prominent placement to encourage investors to pay attention to and compare costs. For funds that offer breakpoint discounts--in other words, they reduce their sales charge percentage if you invest a certain amount or buy more than a specified number of shares--the minimum breakpoint must be listed in this section, and the summary must tell investors where to find additional information.

This section also discloses a fund's portfolio turnover rate and gives a brief explanation of how it affects the fund's transaction costs and performance, as well as the potential tax implications of a high turnover rate if the fund is held in a taxable account. Finally, if a fund lists any fee waivers or expense reimbursements that would affect fund expenses, it must show

how long they are expected to last in the future.

The fund's investment strategies, risks, and performance. This section typically includes the type of securities in which the fund invests and the risks associated with those securities. It also must disclose the risks associated with the fund's strategies. This information includes a bar chart and table showing the variability of the fund's returns, its past performance, and how that compares to a relevant index. It also may include information about where updated performance information can be found online. However, a list of a fund's top 10 holdings is no longer required as part of the summary information.

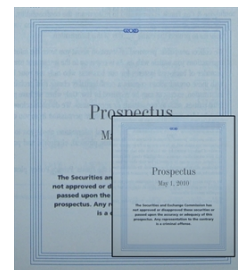
The fund's management. The summary must identify its investment advisors and must list the name, title, and length of service of the portfolio manager(s) responsible for the fund's day-to-day activity. The manager may be an individual or committee who typically is part of the investment advisory firm.

This section also includes a brief discussion of procedures for buying and selling fund shares, and any relevant tax information. A fund also must disclose whether it intends to distribute to its investors capital gains, ordinary income, or tax-exempt income.

Any compensation for a financial intermediary. A fund sold through a third-party financial institution, such as a bank or broker-dealer, must now disclose that it may compensate that financial intermediary, and that the compensation could influence the intermediary. The required language also suggests that you obtain additional information from the intermediary's representative or its website.

The full prospectus isn't going away

A full prospectus, which must be available from the fund's website, includes not only the same information as the summary but a great deal more. For example, it may include a discussion of how the fund's shares are valued, additional information on buying and selling fund shares, and greater detail on financial highlights. The full prospectus also is available on paper by request.

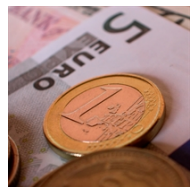


Exchange-traded funds

Prospectuses for exchange-traded funds (ETFs) also are covered by the new provisions, with some exceptions. For example, since ETF shares aren't redeemed directly from the fund, the provision about how to redeem shares doesn't apply for individual investors. However, an ETF prospectus must state the aggregate number of shares it will issue.

An ETF's prospectus must disclose that shareholders may pay more than the NAV and sell at less than NAV because ETFs are traded at market prices. ETFs also must disclose the number of trading days in the last calendar year, and each quarter since that year, on which its market price was higher and lower than its NAV, though it may provide this information online.

Ask the Experts



What does a stronger dollar mean for my portfolio?

In the summer of 2008, investors were watching the dollar shrink. Because interest rates here were still relatively low, investors favored riskier investments

that offered higher returns. The euro's value climbed to a record of almost \$1.60 at one point. But with autumn came the crisis that shook the global financial system. Panicked investors suddenly decided that dollar-denominated assets such as U.S. Treasury bonds didn't look so wimpy after all. Within three months, a euro was worth 30 cents less. Worries about the European debt crisis and whether the euro would even survive as a currency has kept the dollar at roughly the same level or better for much of 2010.

What does that mean for your portfolio? The most obvious impact of a stronger dollar is on the value of overseas investments; the value of holdings denominated in a foreign currency will fluctuate with the exchange rate between that currency and the dollar. Some mutual funds that invest overseas attempt to hedge their currency exposure, using currency futures

and other derivatives to try to limit the impact of that fluctuation on the fund's value. Others do not, hoping that any dollar weakness will increase the fund's value for U.S. investors.

Before investing in an international fund, check its prospectus, which is available from the fund. In addition to carefully considering its investment objectives, risks, fees, and expenses, don't forget the special risks of global investments, including political risks, currency risks, and different accounting standards; all of these can vary considerably by country and region. Also, find out whether the fund is hedged or unhedged. A falling dollar can enhance the returns of an unhedged fund, but the lack of a hedge leaves it unprotected if the dollar strengthens.

A stronger dollar can affect your portfolio even if you don't think you own any foreign investments. Many U.S.-based multinationals get a substantial percentage of their revenues overseas. A stronger dollar can cut into those revenues as U.S. exports become more expensive for overseas consumers. Also, many broad-based mutual funds include a percentage of overseas holdings among their assets.



Why should I care about Europe's debt problems?

When it became apparent last spring that Greece might be unable to make scheduled payments on its government bonds, equities plunged around the world.

How is it possible for the debt of one country to have such a profound impact on investments in a 401(k) plan a continent away?

Investors were worried that Greece's problems with its budget deficit and level of sovereign debt (bonds issued by the national government) were emblematic of issues plaguing other eurozone countries--issues that could create global problems in economies with more global impact, such as Spain. For Europe, sovereign debt is the potential equivalent of the subprime mortgage market in the United States--the first domino that could spark major shocks to the banking industry and, by extension, the global financial system.

Concerns about the level of sovereign debt and the potential for default or restructuring of payments have already affected credit availability internationally; banks are conserving

more capital, worried that they might need those reserves to cover any losses on their sovereign debt holdings. Global investors worry that tighter credit could slow a fragile global economic recovery or cause it to grind to a halt. European businesses and consumers that aren't able to buy U.S. exports could become a problem for U.S. corporations, many of which earn a substantial percentage of their revenues overseas.

Another concern is the stability of the euro itself. If stronger European economies lose the will to help bail out weaker countries, or if highly indebted countries are unable to make drastic and unpopular budget cuts, investors worry that the euro could be in peril. Equities hate uncertainty wherever it is, and the specter of chaos in the global financial system can affect markets worldwide. To combat these problems, European leaders have adopted many of the same steps taken in the United States during the 2008 financial crisis, such as establishing a massive lending facility and subjecting large banks to stress tests to determine their ability to withstand financial shocks.

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