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Speculating on the Future of the Federal Estate Tax

What's the future of the federal estate tax? All we know is that no one knows for sure; it's all speculation. So, let's take a look at what could happen. There are five possibilities: (1) Congress could extend current tax law (commonly referred to as the "Bush tax cuts"); (2) Congress could do nothing, essentially turning the calendar back to 2001; (3) Congress could compromise, agreeing on something between the 2001 tax rules and the rules that apply in 2012; (4) Congress could enact new estate tax reform; or (5) Congress could repeal the estate tax altogether.

Note: *Only a few of the estate tax laws that are affected are discussed here.*

Congress could extend current tax law again, probably for two years

That would mean the top gift and estate tax rate would remain at 35%. The generation-skipping transfer (GST) tax (this is an additional tax that's imposed on transfers to beneficiaries who are two or more generations below you) would also remain at a 35% tax rate. The gift and estate tax exemption (may also be referred to as an exclusion) would remain at $5,120,000 (plus any adjustment due to inflation) plus any deceased spousal unused exclusion amount (DSUEA).

The DSUEA is the amount of the gift and estate tax exemption that the first spouse to die does not use. This amount can be transferred from the estate of the first spouse to die to the surviving spouse. This is referred to as portability. Portability would remain.

The GST tax exemption of $5,120,000 plus any adjustment due to inflation would remain. There is no DSUEA for the GST tax (i.e., the GST tax exemption is not portable between spouses).

The smart money is on this possibility. It has been Congress's tendency of late.

Congress could do nothing

Congress could allow all or some of the provisions that sunset to expire, reverting to the 2001 tax rules. The top gift and estate tax rate would be 55% with a 5% surtax on estates that exceed $10 million but do not exceed $17,184,000. The GST tax rate would also be 55%. The gift and estate tax exemption would be $1 million. And, the DSUEA would no longer apply. The GST tax exemption would be $1 million indexed for inflation (estimated so far to be $1,360,000).

Some analysts have proposed letting the Bush tax cuts expire as part of a plan to balance the budget over time.

Congress could compromise

Congress could pass a compromise bill that would set the top tax rate to 45% and the exemption amount to $3.5 million. Whether portability would expire or be extended is anyone's guess.

President Obama supports this option. His 2013 budget plan would return the gift and estate tax, and the GST tax, to 2009 levels; the top tax rate would be 45%, the exemptions would be $3.5 million (but only $1 million for gift tax purposes), and portability would be made permanent.

Congress could enact estate tax reform

Many believe that permanent and comprehensive estate tax reform is needed. However, the political landscape is probably not currently amenable to this option. Besides, permanent tax reform does not really mean that it will be permanent (it could, of course, be modified or repealed by future legislation).

Congress could repeal the estate tax altogether

The arguments for and against the repeal of the estate tax continue to wash in, like ocean waves. The tide was high for repeal a few years back, but the current economic and fiscal situation may have slowed its momentum, and the tide seems to be ebbing.

New 401(k) Plan Disclosure Rules

In October 2010, the Department of Labor issued new regulations that require all self-directed 401(k) plans--both those that choose to comply with ERISA Section 404(c) and those that do not--to provide the same detailed information to participants about the plan and its investments, on a regular and periodic basis, so that participants can make informed decisions with regard to the management of their individual accounts.

You may have heard about new disclosure rules that will soon apply to 401(k) plans. Before describing what's ahead, however, a look back may be helpful. (While we'll refer to 401(k) plans in this article, the new rules also apply to other employer-sponsored plans that allow participants to direct their own investments, commonly referred to as "self-directed plans.")

Background

Most 401(k) plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA) (governmental plans, owner-only plans, certain 403(b) plans, and certain church plans are not). One of the primary reasons Congress enacted ERISA was to protect retirement plan assets, and one of the important ways ERISA does so is through its rules governing the conduct of plan fiduciaries.

In general, plan fiduciaries include the plan administrator, anyone providing investment advice for a fee, and anyone who exercises discretionary authority or control over the plan or the plan's assets. Plan fiduciaries must discharge their duties with respect to the plan prudently, and solely in the interest of participants and beneficiaries.

A fiduciary who breaches his or her duty to the plan may be personally liable for any losses that occur as a result of that breach. The investment of plan assets is a fiduciary act governed by ERISA's fiduciary standards.

Section 404(c) plans

But who is responsible for losses in a self-directed plan, where the participants themselves, and not the plan sponsor or an investment manager, select the investments for their retirement accounts? To answer this question, in 1992 the Department of Labor (DOL) issued regulations that allow 401(k) plan fiduciaries to avoid responsibility for losses in self-directed plans that occur as a result of a participant's exercise of investment control over his or her own account, if specific requirements are satisfied.

To avoid liability, self-directed plans must provide participants with a diversified choice of investments, and must disclose very specific information about the plan and its investments (and comply with certain other requirements). While these rules are voluntary, many (if not most) 401(k) plans choose to comply, in order to shift liability for losses away from the plan's fiduciaries.

A 401(k) plan that complies with these rules is known as a "Section 404(c) plan," after the section of ERISA that governs self-directed plans. A plan's summary plan description (SPD) should indicate if the plan intends to be a Section 404(c) plan.

What's changing?

As self-directed plans have grown more popular, the DOL has become increasingly concerned that participants might not have access to, or might not be considering, information critical to making informed decisions about the management of their accounts--particularly information about investment choices, fees, and expenses.

As a result, in October 2010, the DOL issued new regulations that require all self-directed 401(k) plans--both those that choose to comply with Section 404(c) and those that do not--to provide the same detailed information to participants about the plan and its investments, on a regular and periodic basis, so that participants can make informed decisions with regard to the management of their individual accounts.

Some information must be provided on an annual basis, and some information must be provided quarterly. For calendar year plans, the initial annual disclosure must be furnished no later than August 30, 2012. The first quarterly statement must be furnished no later than November 14, 2012 (for July through September 2012).

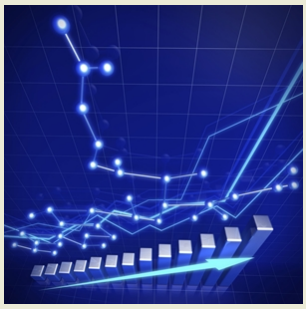
Participants in 401(k) plans that comply with ERISA Section 404(c) are already receiving most of the information required by the new regulations. In general, more detailed information about investment fees and expenses must now be disclosed to participants.

Another change is that plan investment information must now be provided in chart form, so that participants are better able to compare investment alternatives. And plans will no longer be required to automatically provide a prospectus to participants, although one must be provided upon request.

Which plans must comply with the new rules?

These new disclosure rules apply to 401(k) plans and other plans that allow participants to direct their own investments, but they don't apply to IRAs, SEPs, or SIMPLE IRA plans. They also don't apply to plans that aren't covered by ERISA.

Stock Market Metrics: Playing the Numbers



Fundamental metrics based on the operations of individual companies also can be aggregated and averaged to suggest the state of an index comprised of those stocks.

There are no infallible guides to stock market movements. However, that doesn't stop investors from using various measurements to try to divine the current and future direction of a stock's price or the equity markets as a whole. Here are some common methods (or metrics) for gauging the stock market.

Gauging volatility

The CBOE Volatility Index®, informally referred to as the VIX® and nicknamed "the fear index," measures real-time changes in the prices of a group of S&P 500 30-day options traded on the Chicago Board Options Exchange. When financial markets are stressed, prices of those options tend to rise as investors try to hedge any potential negative impact on their portfolios. The more concerned options traders are about potential instability, the higher the VIX tends to go; conversely, when fears subside, the VIX tends to be lower. How high is high for the VIX? During the worst of the 2008 financial crisis, it spiked to 89 at one point. Since then, it has gradually returned to more normal levels in the teens and twenties.

Moving averages

A moving average reflects a stock's average price or an index's value over a specified period of time (for example, the last 50 days). As a new average for the time period is calculated each day, the earliest day's data drops out of the average. The results are typically depicted as a line on a chart, which shows the direction in which that rolling average has been moving. For example, a stock's 50-day moving average (DMA) shows whether the stock's short-term price has been moving up or down; a 200 DMA smooths out shorter-term fluctuations by using the longer 200-day rolling time period. When a stock's price moves above its 50-day or 200-day average--two of the most popular gauges--technical analysts typically consider it a bullish signal that the stock or index has momentum. Conversely, when the price moves below its moving average, it's considered a bearish signal suggesting that any uptrend could be reversing.

Golden cross/death cross

When the short-term moving average of a stock or index rises above a longer-term average--for example, when the 50 DMA moves upward above its 200 DMA--the situation is referred to as a "golden cross." It shows that the stock's most recent price action has been increasingly positive, suggesting that investors have grown more bullish on the stock. Technical analysts also look for golden crosses with various stock indices--the S&P 500 is perhaps the most popular--to try to gauge the potential future direction of the equity markets.

The so-called "death cross" is the inverse of a golden cross. It occurs when the 50 DMA falls below the 200-day, and is considered a bearish signal, especially when seen in a broad market index such as the S&P 500. Such signals may or may not be valid; there are arguments on both sides. However, many of the automated trading systems that are responsible for a large percentage of all transactions are guided at least in part by such perceived quantitative signals. As a result, an index or stock can experience volatility--either up or down--as it reaches either of these points.

Fundamental metrics

Other stock market metrics rely on the nuts and bolts of corporate operations that are reflected on a company's balance sheet--so-called "fundamental data." Though based on the operations of individual companies, they also can be aggregated and averaged to suggest the state of an overall stock market index comprised of those stocks. The following represent some frequently used fundamental stock metrics.

Earnings per share (EPS): This represents the total amount earned on behalf of each share of a company's common stock (not all of which is necessarily distributed to stockholders). It is calculated by dividing the total earnings available to common stockholders by the number of shares outstanding.

Price-earnings (P/E) ratio: This represents the amount investors are willing to pay for each dollar of a company's earnings. Calculated by dividing the share price by the EPS, it can be used to gauge investor confidence in the company's future. A ratio based on projected earnings for the next 12 months is a forward P/E; one based on the previous 12 months' earnings is a trailing P/E. Like EPS, P/E is considered an indicator of how expensive or cheap a stock is.

Return on equity (ROE): This is a way to gauge how efficient a company is, especially when compared to its peers in the industry. This percentage compares a company's net income (usually for the last four quarters) to the total amount of shareholders' equity (typically, the difference between a company's total assets and its total liability).

Debt/equity ratio: Obtained by dividing a company's total liability by all shareholder equity, this percentage suggests the extent to which the company relies on borrowing to finance its growth.

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What is a captive insurance company?

A captive insurance company (CIC) is a corporation established either onshore or offshore to insure the risks of its parent company or a group of companies. While there are many benefits that can be derived from a CIC, the primary goal of any CIC is to reduce the parent company's overall cost of risk management.

CICs may allow insured companies to decrease their insurance and reinsurance costs, control premium costs, and increase profits and cash flow. They also may provide for coverage of unusual risks that are not customarily insured by commercial insurers, allow the insured direct access to reinsurance markets, improve risk management, and afford possible tax benefits.

There are many different types of CICs. The most common are pure captives--wholly owned by one parent and/or its affiliated companies; and group captives--owned by a number of similarly sized unaffiliated entities that are usually in the same line of business (e.g., doctors). Generally, CICs are run by a board of directors designated by the parent company.

CICs generally can insure risks ordinarily covered by commercial insurers, including malpractice coverage, automobile liability, workers' compensation, employee health-care costs, product liability, property damage, liability umbrella coverage, wrongful termination, and sexual harassment. Regardless of the type of risk, like most commercial insurance, the CIC typically will transfer some of its risk to another insurance company, referred to as reinsurance. This allows the CIC to control the amount of economic risk exposure it retains.

Generally, the parent company can deduct premiums paid to the CIC, so long as the IRS recognizes the captive as a true insurance arrangement. Also, if certain requirements are met, the premiums received by the CIC are tax free.

Establishing a CIC involves a high capitalization commitment, significant administrative costs, state or foreign domiciliary regulation, and the possibility of inadequate loss reserves to cover unexpected losses. But after careful analysis, a CIC may be a way to finance a company's risk at a reduced cost.

What is directors and officers insurance?

Corporate directors and officers assume obligations to shareholders, third parties, and the company itself. Directors or officers are exposed to personal liability as a result of their acts or omissions with respect to their duties. While the company may indemnify its executives for certain claims, there may be instances where the company is unable to offer personal asset protection. Directors and officers (D & O) insurance provides financial protection for liability claims brought against individuals acting in their capacity as corporate directors or officers.

While commercial D & O insurance generally can be tailored to meet the specific risks of the company and its management, most policies provide coverage for the following types of claims: employment-related claims such as wrongful termination, sexual harassment, and discrimination; claims of securities fraud such as intentional concealment of information, or insider trading; and shareholder derivative lawsuits for claims against board members brought on behalf of the corporation, usually alleging mismanagement of assets.

D & O insurance differs from errors and omissions insurance and general liability coverage. D & O insurance covers claims for nonphysical harm arising out of the performance and duties of company management. Errors and omissions or professional liability insurance protects a business or individual from claims made by consumers of products or services. Corporate general liability insurance protects board members and officers from claims arising out of bodily injury and property damage.

Certainly you should consider D & O insurance if you serve as a member of a board of directors or officer of a publicly traded corporation. But even if you manage a closely held corporation, partnership, or trust, you may be susceptible to lawsuits from stakeholders such as bondholders, creditors and lenders, customers, employees, and regulatory agencies. Consult your financial professional or legal representative to get more information about the potential risks you face as an officer or director, then consider asking your company to protect you from possible claims by purchasing D & O insurance.

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