Estate Taxation Gets Trickier

*Perhaps You Can’t Magically Change The Future, But You Can Plan For It*

Of course there’s much to like in the estate tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001: The unified exemption amount is going up, federal estate tax rates are going down, and estate taxes are repealed in 2010.* But some disconcerting provisions, with extraordinarily complex implications, accompany all that good news. Even though the incessant changes coming over the next few years make it tempting to take a wait-and-see attitude toward formulating or adjusting estate plans, this state of flux is precisely what makes planning now so important. Possible concerns to address with your estate planning team include—

**Adjusting for unintended consequences.**

For example, the A-B trust arrangement has become a popular tool for maximizing a married couple’s use of the exemption amount and minimizing estate taxes for their children. Typically, assets directed into the B (bypass) Trust are equal to the exemption amount, with the balance going to the A Trust for the spouse. As the exemption amounts change, asset distribution according to such a typical formula could run counter to your intentions. Assume, at the time of death, an estate is worth $3.5 million and trust language specifies that assets equal to the exemption amount go into the bypass trust. As you can see from the following, assets going to the spouse are gradually reduced to zero; in 2010, it’s the other heirs who get nothing.

### Table: A-B Trust Arrangement

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets to A Trust (Spouse)</th>
<th>Assets to B Trust (Bypass Trust)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002–2003</td>
<td>$2,500,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2004–2005</td>
<td>$2,000,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2006–2008</td>
<td>$1,500,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$0</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010 (repeal)</td>
<td>$3,500,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

*All provisions of the law are repealed on December 31, 2010.*

**Assessing the impact of other taxes.**

Provisions in the new law may actually increase the tax liability your heirs face.

*State death taxes.* Starting this year, the federal estate tax credit allowed for estate taxes assessed at the state level will be gradually reduced. The credit will be eliminated in 2005 and replaced with a deduction. In states like California, where the amount collected in estate taxes has been pegged to the exact amount of the credit, the tax paid to the state was effectively offset by the dollar-for-dollar credit. If the amount collected by the state is reduced to correspond to the shrinking credit, state revenue is reduced accordingly (California estimates a “loss” of $367 million in 2002-03, rising to $1.27 billion in 2005-06. Source: www.dof.ca.gov). Since giving up revenue is not something state governments are typically likely to do, the result may be a higher combined estate tax bill.

*Federal income taxes.* Much further out on the horizon, but potentially costly for heirs if it stands, is the way in which the cost basis of a decedent’s property will be determined beginning in 2010. Generally, the basis will be the lesser of:

(Continued on back page - Click Here)
Annuities: Another Way To Boost Tax-deferred Savings Opportunities

Tax-deferred annuities can augment IRAs and 401(k) plans, giving you a way to bolster retirement savings. The investment of premium dollars is made on an after-tax basis, but earnings can grow tax-deferred until withdrawn at retirement. With most annuities there is no cap on how much you can invest and you are not required to begin withdrawals at age 70 1/2 (withdrawals before age 59 1/2, however, may be subject to a 10% tax penalty).

You can choose a fixed or variable tax-deferred annuity. Fixed annuities have stated interest rates, guaranteed by the issuing insurance company. The interest rate may be changed over the life of the contract, but will not be less than a specified guaranteed rate. Variable annuities give you the opportunity to invest in mutual funds—actually called subaccounts—so you can diversify among equities, bonds, and money market securities. Since the value of a variable annuity will depend on the performance of your investments, it’s important to apply the same diversification principles to annuity investments as you would to other investment accounts.

Your Senior Investment Specialist will be happy to give you more information about tax-deferred annuities.

All annuity guarantees are subject to the claims-paying ability of the issuing insurance company.

The mutual funds I’ve purchased over the years seemed okay until recently. Maybe I’m not as diversified as I thought, because now they all look dismal. I still prefer mutual funds over picking my own stocks, but I’m not sure what to re-build with if I dump them all. Any ideas?

First, you may not want to be too quick to sell everything. Even with a portfolio diversified enough to perform admirably over the long term, there’s no guarantee that short-term performance on one or more fronts won’t seem a little bleak. But it certainly won’t hurt to take a fresh look at your portfolio to see if you’re amply diversified and to plot a course for the future.

Start by re-visiting your asset allocation plan to be sure assets are sufficiently diversified among broad investment classes—equities, bonds, and cash—to reach both short- and long-term goals. You can then evaluate mutual funds within each class for their diversification potential, as well as for their individual performance potential. As food for thought, here’s a sampling of fund types within a hypothetical asset mix (your own asset mix may differ significantly from this):

<table>
<thead>
<tr>
<th>55% Equities</th>
<th>43% Bonds</th>
<th>2% Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-, mid-, small-cap: Growth</td>
<td>Tax-free municipal bonds</td>
<td>Money cash market funds</td>
</tr>
<tr>
<td>Large-, mid-, small-cap: Value</td>
<td>Short-, intermediate-, long-term bonds</td>
<td></td>
</tr>
<tr>
<td>Total Return (Balanced, Growth &amp; Income, Equity/Income)</td>
<td>High-yield bonds</td>
<td></td>
</tr>
<tr>
<td>International Sector</td>
<td></td>
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</tbody>
</table>

To choose equity funds that complement—rather than duplicate—each other, it’s useful to categorize funds by characteristics like:

- The size of company the fund tends to invest in
- The fund manager’s investment style—value or growth
- Whether the fund seeks capital appreciation alone or invests for income too
- Where the fund invests—the U.S. or internationally
- If the fund concentrates on a specific sector of the economy

If you look at the historical performance of funds with different characteristics, you’ll see that they are prone to behave somewhat differently as we move through economic cycles and

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changing markets. Choosing funds that tend to have these complementary behaviors has proven to be the most effective long-term strategy for stabilizing, and even enhancing, returns in a portfolio.

When constructing your bond fund portfolio, three major considerations to take into account are:

- Whether you can benefit from the tax-free income municipal bond funds generate
- Maturities—keeping in mind that long-term bond prices are most sensitive to interest rate changes
- Credit quality—choices can range from Treasury securities, backed by the U.S. government, to high-income issues that present higher yield opportunities for the increased credit risk you take.

The type and number of funds you ultimately choose will depend on such factors as the amount of investable assets you have, the level of risk you’re comfortable with, and how much time you want to spend managing your portfolio.

Your Senior Investment Specialist Is Here To Help

Need just a little personalized guidance? Even the most committed do-it-yourself investor can use some help from time to time. Your Senior Investment Specialist can assist you with reviewing your goals, putting your asset allocation plan together, and selecting specific investments to help you achieve your investment objectives.

Want a more systemized approach? Ask your Senior Investment Specialist about Lifetime AdvantageSM. Lifetime Advantage is an investment program that allows you to invest in one of seven portfolios—each with a specified asset allocation target—comprised of several pre-set mutual fund selections. Not only are you spared the task of creating a diversified portfolio on your own, but ongoing management tasks such as rebalancing your portfolio are also automatically done for you. You can choose between a Single-Manager or Multi-Manager program, with an initial investment of $50,000 or $100,000 respectively.

Your Senior Investment Specialist can be reached in the Investment Center of your local Union Bank of California banking office.

The Credit Challenge—Staying On Course

Reaching important goals—owning a home, educating children, building financial assets—almost always requires borrowing money. But falling into one or more debt traps can seriously impede attainment of the same, as well as other, life goals. When it comes to avoiding those traps, the more you know, the more you stay in control. So here are six questions (with answers on the back page) to serve as a brief reminder about a few debt facts and traps. If you want to test your knowledge, circle all answers that apply to the following:

1. Which of the following interest payments are not tax-deductible?
   (a) margin loan interest if used to buy taxable securities
   (b) qualified home mortgage interest
   (c) interest on your home equity line
   (d) interest on a loan from your 401(k) plan

   The IRS will present you with a tax bill if
   (a) a debt you owe is forgiven or cancelled
   (b) you can’t repay a 401(k) plan loan

2. As a strategy to avoid margin-call losses, you could
   (a) borrow less than the full amount of credit available
   (b) secure the loan with the least volatile securities in your portfolio
   (c) keep an emergency source of liquidity to avoid selling securities at a loss

3. With a $5,000 balance on a credit card charging 13% APR, how long will it take to pay off paying $100 every month?
   (a) 3 years
   (b) 5 years
   (c) 6 years

4. Referring to question (4), if the interest rate is 18% APR it will take nearly two years longer and cost another $2,000 to pay it off.
   (a) True
   (b) False

5. The attractions of 401(k) plan loans include
   (a) ease of access
   (b) you pay principal and interest to yourself
   (c) it’s better than a premature withdrawal from the plan
   (d) there’s no downside since you’re borrowing from yourself
Estate Planning (continued from front page)

decedent’s adjusted basis in the property or the fair market value on the date of death. Some assets will be eligible for a limited increase (step-up) in basis, as follows:

Starting basis of assets qualifying for basis increase
- assets eligible for increase are selected by the executor or trustee
- certain assets—including IRAs, pension payouts, and other assets considered “Income in Respect of a Decedent”—are not eligible for increase

Aggregate basis increase allowable (apportioned among selected assets)
- $1.3 million for qualified assets passing to non-spouse
- additional $3.0 million for qualified assets passing to spouse
- limits may be increased by unused built-in losses and loss carryovers

Ending basis of assets
- basis of selected assets cannot exceed their fair market value

Reviewing the role of life insurance. Life insurance has long been used to provide the liquidity necessary for paying estate taxes. Although the prospect of repeal might seem to negate the need for insurance, such thinking could turn out to be short-sighted. First of all, repeal is not permanent. And, even with reduced levels of federal estate taxes, heirs may need liquidity for increased state death taxes or income taxes. As changes unfold, the income-tax-advantaged features of life insurance could make it an increasingly important estate planning tool.

Re-considering the choice of executor or trustee. Will separate estate tax calculations be necessary for property held in multiple states? Who will face the arduous task of figuring out the cost basis of assets accumulated over decades, as well as complying with the reporting requirements the new law imposes? It’s wise to review whether the person asked to handle your estate will have the time and expertise to manage the added complexity.

Clarifying goals. Although no one likes the thought of paying more in taxes than absolutely necessary, it’s important to remember that planning for federal estate taxation is only one of many objectives to be achieved through the estate planning process. Consulting with your estate planning team is the best way to ensure that your plans are flexible enough to achieve all your goals.

Credit Challenge

Answers and Comment:

1. (d). Margin loans may be used for any purpose, but interest is only deductible in the year paid if used to buy taxable securities. Mortgage interest deductibility is subject to limitations on the amount of indebtedness (generally $1 million for home acquisition debt; $100,000 for home equity debt).

2. (a) and (b). Although there are exceptions, cancelled debt is generally treated as taxable income. Default on a 401(k) plan loan is treated as a taxable distribution and may trigger premature distribution penalties as well. While default may seem like a remote possibility, a sudden layoff can at least mean scrambling for sources of repayment to avoid the tax liability.

3. (a), (b), and (c). Used prudently, margin debt can be an easily accessible, reasonably priced way to enhance return on investment and take advantage of investment opportunities without liquidating other assets or using more expensive sources of credit.

4. (c). It will also cost about $2,300 in interest. By increasing payments by $25 per month, repayment time is cut to about 4 1/2 years and interest cost cut by nearly $700.

5. (a). When interest rates are low, debt can be particularly seductive. But when rates rise again, the increased cost of debt service decreases financial flexibility.

6. (a), (b), and (c). Along with the tax consequences of default, extensive borrowing can impair the ability of savings to grow for a secure retirement.

Have questions or topics you would like to see addressed in Investment Insight?

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