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Human behavior is a significant factor in financial planning and investing. This could be Garrison Keillor's "Lake Wobegon" Effect. Where "all the women are strong, all the men are good-looking and all children are above average."

Nissin Nicholas Taleb, in "The Black Swan", states there are gaps between what you know and what you think you know. This may contribute to the magnitude of forecast errors. He argues that we act as if we can predict future events. Often we convince ourselves that we did know the event was going to happen, or should have foreseen it.

You should stop, listen and watch for more information before reacting. Often the impact has passed by the time you become aware of it. There are probably others that view the information differently and/or there is offsetting information. Take a long term perspective.\*\*\*\*\*] always appreciate your referrals.\*\*\*Joe

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# Current Financial Topics

October 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.

## 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](http://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](http://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.

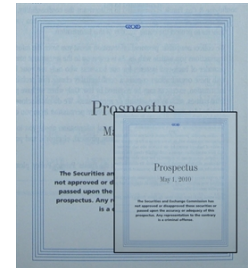
**The fund's management.** The summary must identify its investment advisors and must list the name, title, and length of service of the portfolio manager(s) responsible for the fund's day-to-day activity. The manager may be an individual or committee who typically is part of the investment advisory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

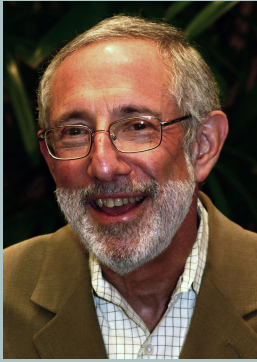


### Exchange-traded funds

*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.*





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## Ask the Experts



### Does homeowners insurance cover personal liability?

Typical homeowners insurance provides limited coverage for personal injuries or property damage to others for which you or members of your family

living with you may be legally responsible. The injuries or damages don't have to occur on your property. Your policy will describe what types of claims are covered, and coverage may vary by state, policy type, and insurer, so check with your carrier or agent for particular coverage questions.

Liability protection is comprised of two parts: personal liability and medical payments. Personal liability covers claims or lawsuits against you arising out of bodily injury or property damage to others caused by an accident on your property, or by accidents away from your property, caused by you or family members who live with you. The coverage also pays for your legal defense should you be sued for a covered claim. However, coverage does not extend to losses caused by intentional acts, business related incidents, accidents covered by auto insurance, or claims covered by

worker's compensation insurance.

Typically, personal liability provides a minimum of \$100,000 of coverage "per occurrence." Also, unlike other types of property coverage, there is no deductible for personal liability or medical payments coverage. If you need more coverage, you might consider increasing your personal liability coverage limits, or buying an umbrella policy that provides additional personal liability coverage in excess of your homeowners coverage.

Medical payments pays medical expenses incurred by people accidentally injured on your property, regardless of fault, up to policy limits. Injuries to you or family members living with you are not covered, nor are injuries resulting from activities that involve your business.

Examples of types of liability claims homeowners insurance may cover include: your dog wandering into your neighbor's yard and biting the house painter; a neighborhood child getting hurt climbing your fence, despite your repeated warnings; and your errant golf shot accidentally striking another player in the head.



### Will my homeowners insurance cover tree damage?

The answer is yes and no. Throughout the year, many areas of the country face powerful storms that often result in significant property damage caused by downed

trees and limbs. If you fall victim to this type of property damage, here's some information that may be helpful in figuring out what your insurance will and won't cover. Bear in mind that homeowners insurance coverage may vary by state, policy type, and insurer, so check with your carrier or agent for particular coverage questions.

If there is damage to your property caused by trees, your homeowners insurance is the policy to file a claim with--regardless of whether the tree was on your property or a neighbor's. Likewise, if your tree causes damage to a neighbor's property, their policy will cover the claim (although exceptions may apply, depending on the circumstances).

If a tree falls on your property but does no actual damage to any structure, then there is likely no coverage to provide for the cleanup.

There must be damage to "real property," which usually includes your home and its contents, a fence, shed, outdoor play equipment like a swing set, a patio, or a driveway.

Most homeowners policies cover the entire cost of repairs to your home caused by downed trees or limbs, subject to any applicable deductible. Damage to other structures or property like a detached garage, shed, or fence is covered under the "Other Structures" part of your policy for up to 10% of the available coverage for your dwelling.

Homeowners insurance typically also covers the cost of actually removing the downed tree or limb from your property, up to a cap per tree. And if a tree or shrub is damaged, your homeowners insurance may pay a limited amount to replace the damaged tree or shrub, depending on the circumstances. However, your homeowners insurance will not cover damage to your car caused by fallen trees or branches. Rather, your auto insurance will cover the cost of repairs if you have comprehensive (fire and theft) coverage, up to applicable policy limits and deductibles.