

MARKET COMMENTARY

YEAR-END 2001

William L. Haas

Two Thousand One may have been the most eventful year ever experienced in twentieth century American financial and estate planning. The changes announced during the first two weeks of the new year concerning the distribution planning for retirement plans were much more important than noticed on first assessment. In May, Congress enacted changes in the law concerning education, retirement, income, and estate tax issues that were among the most important of the thirty years that I have been in practice. In September came the terrorist attack on the World Trade Center and the start of an international war on terrorism that is anticipated to last for years. Although world attention has been centered on the loss of life brought about by that incident and its aftermath, the loss in property values, business, and of standard of living has been staggering. At the end of the year, we, as investment planners, were looking at the second straight year of market decline.

How does one write a year-end newsletter summarizing what occurred in 2001? For me, it was made a little easier. I went to New Orleans.

I went to New Orleans not for the usual reasons but because, during the week of January fifteenth it was the site of a meeting of the American Bar Association's Tax Section and of my beloved tax Group. For three days I attended sessions on the new tax law and let the messages delivered by outstanding speakers on what might seem disparate issues impact me. I stayed in my room at night to read tax law and financial subjects. I was listening to and reading the output of some of the best legal minds in the country. But no one seemed to bring all the events of the past year together as an organized whole.

Then, on the afternoon of my last day in New Orleans, I enjoyed the company of one of my favorite people, Bruce Temkin, whom I first met when we were panelists together for ALI-ABA programs in the eighties. Bruce is an actuary, but much more than that he is a teacher who has the ability of simplifying the most complex of topics and making them relevant for his audience of attorneys and for their clients. To visit with him one on one is a delight. The afternoon with Bruce visited a number of topics including, as I will relate later, biomedicine. When Bruce spoke at the end of that afternoon, he seemed to bring together much of what I had been reading and hearing. I will borrow liberally from his ideas as I proceed with this letter.

JANUARY 2001: REQUIRED MINIMUM DISTRIBUTIONS LIBERALIZED

One makes best sense of this regulatory change by first consulting an actuarial table summarizing life expectancies at different retirement ages for Couples Living in the United States.

JOINT LIFE EXPECTANCIES OF U.S. COUPLES

Attained Age of Couple	Joint Life Expectancy
50	89.3
55	89.5
60	89.7
65	90.1
70	90.7
75	91.5
80	92.8
85	94.6

This table¹ indicates that there is a greater than 50% probability that one member of a couple having attained age 70 would live to be ninety years old. But there is a problem. The table is already out of date due to breakthroughs in biomedicine. Already medical breakthroughs have improved that longevity. Within the next twenty years, the life expectancy for such a couple is anticipated to be much greater than 100.

The law on the books until January, 2001 required most retirees who attained age 70.5 to begin taking each year from their retirement plans in an amount not less than what was prescribed in a table published by the Internal Revenue Service. Although given a choice of the manner in which this taking was to be accomplished, most retirees chose a system that might well require the exhaustion of the retirement account by age ninety.

The new law greatly liberalizes the requirements describing required minimum distributions and the naming of plan beneficiaries. Old law mandated that the choice of beneficiary would, in most instances, be irrevocable after the participant's age 70.5. Now, certain changes can be accomplished up to the year-end following the year in which the participant dies. To take full advantage of this liberalization it is absolutely vital that the appropriate parties be named as contingent beneficiaries of the relevant IRA or retirement plan.

Naming of the appropriate party to be the beneficiary or contingent beneficiary of your retirement plan can be the most important estate planning move that many clients will ever make. Such a nomination can preserve the tax and creditor protection available from your retirement plan for your beneficiaries not for just a year or two but, perhaps, for as many as forty or fifty years.

¹ Table 6-2 from The Terrible Truth About Investing by Bruce J. Temkin. Copyright Fairfield Press, 888-820-5958.

Unfortunately, many unwary plan participants will never avail themselves or their heirs and beneficiaries of the benefits of such a plan designation. There are several reasons. Among them: (1) estate planning attorneys are not necessarily versed in employee benefits or retirement planning law and will miss this important estate planning opportunity; (2) many plan participants utilize the mass-processed forms available from insurance companies, brokerage firms or banks. A number of these forms specify the contingent beneficiary for their accounts and do not permit alternatives.

The appropriate naming of your plan beneficiaries should be an essential piece of your overall estate plan.

This discussion of the required minimum distribution rules and their integration with life expectancy tables should trigger a review as to whether the assets you have accumulated for retirement will, in fact, be sufficient. Bruce Temkin has published the following table, Chart 4-11 from THE TERRIBLE TRUTH ABOUT INVESTING, Copyright Fairfield Press, 888-820-5958.

TAX RATE	LUMP SUM NEEDED WITHOUT TAXES	LUMP SUM NEEDED INCLUDING TAXES
	25 Years	
15%	\$152,000	\$180,000
25%	\$152,000	\$204,000
35%	\$152,000	\$234,000
	30 Years	
15%	\$169,000	\$199,000
25%	\$169,000	\$226,000
35%	\$169,000	\$260,000

Based on Bruce's computations, for a person in a 35% tax bracket, \$234,000 would be required to provide an inflation adjusted spendable income of \$10,000 per year for twenty-five years while \$260,000 would be required to maintain that same inflation adjusted spendable income for thirty years. According to Bruce's computations, nothing would be left in the required accounts on the expiration of the twenty-five or thirty year periods.

My own computations have indicated the need for considerably less capital to maintain the indicated spending levels but, in a post 9/11 world, I am willing to suggest that Bruce may be closer to being correct.

In January 2001, the IRS issued final rules concerning required minimum distributions from retirement plans. The new regulations will have the effect of allowing plan participants and their beneficiaries to stretch out the period during which distributions can be taken. This regulatory change was one of several moves made by the government in 2001 that together are seen as promoting the use of qualified retirement plans by small company employers. Stretching out the period during which distributions can be taken is

certainly a more realistic approach at a time when the longevity of the worker is growing rapidly, helped along by advances in modern medicine. Making retirement plan use by small employers more attractive is indeed wise when, increasingly, the sufficiency of public retirement programs such as social security is being drawn into question.

With the table immediately preceding, it may be appropriate to see how what you have accumulated for retirement measures up to what is considered necessary in providing you an adequate revenue stream for your golden years.

LEGISLATIVE CHANGES ENACTED MAY, 2001 AFFECTING EDUCATION, RETIREMENT, INCOME AND ESTATE TAX ISSUES:

The Group that I met with in New Orleans has, as its purpose, advancing the tax benefits of small business, its owners and executives. Founded in 1969, it has been active in seeking legislative changes, substantial portions of which were enacted in 2001, promoting retirement and estate planning for these classes. In fact, leaders of the Group actually drafted a number of the retirement provisions found in the new law. Many of us found victories in this new legislation for which we had been fighting since the early eighties.

Unfortunately, the new legislation also had some serious drawbacks, the most serious of which was its need to comply with the Byrd Amendment. The Byrd Amendment, mandated that legislation affecting revenues more than ten years in the future, must pass by a super majority. A majority must receive a minimum of sixty votes in the Senate. Thus, the May legislation, while sweeping, would not become effective immediately but be staged into the law with progressive effect. With each session of Congress, additional pieces of legislation would come into effect unless (and this could easily happen) Congress decided to delay or revoke the provisions for that year or what had come before. Worst of all, unless a future Congress legislated that the law continue, it would become null and void in 2011; the Internal Revenue Code as effective before the legislation would then again become law.

Let's summarize some of the critical provisions of the new legislation and their impact on you, our clients:

EDUCATION: Both Republicans and Democrats fought to become associated in the public image as the party of education. For that reason, the provisions designed to help with the financing of educational costs for the individual constituent were particularly generous. For example, the educational IRA was expanded to provide for an annual non-deductible contribution of \$2000 in 2002. Funds could be distributed to pay for qualified educational expenses (tuition, room/board, books) and can be used at any level of education from FIRST GRADE UP, including private schools. Contributions to the plan must cease when the beneficiary obtains age 18. However, the educational IRA is limited to use by taxpayers who fall under certain limits for adjusted gross income. As with many provisions in the tax code, the limits are phased out for high-income earners, starting at \$190,000 for married filers in 2002. Also, prior to 2002, contributions were

not permitted if contributions were made to a state tuition program on behalf of the beneficiary.

For tax practitioners, the center stage of education planning was now occupied by the improved Section 529 plan. The 529 plan was not encumbered by income restrictions applicable to either the donor or the beneficiary. It permitted the individual to accelerate his ability to give \$10,000 (NOW INCREASES TO \$11,000 for 2002) annually to as many donees as he or she desired without transfer tax. The 529 plan permitted the donor to lump five years of those annual exclusions into one year or to transfer up to \$55,000 at one time into the plan. (Of course, he would not be allowed to make further transfers to that donee for the next five years). Once in the plan, the moneys accumulated tax deferred and could be withdrawn for qualified higher educational expenses without tax. Qualified higher education expenses include tuition, fees, room and board, books, and supplies at any accredited post-secondary institution in the US.

Should the donor die, the moneys (with certain exceptions) would not be attributed to his estate for estate tax purposes. Should he need at some later date to pull back some of the money for his own use, this could be done merely by paying ordinary income tax on the accumulated growth and a penalty tax of 10%. As so constituted, the 529 plan has become not only an invaluable tool for education funding, but has significant use for both retirement and estate planning.

RETIREMENT PLANS: For small businessmen to adopt retirement plans for themselves and their employees, it was necessary to increase their financial inducement to do so. Legislation adopted in the late nineties, and particularly legislation adopted in May of last year, greatly liberalized the applicable plan provisions. Particularly significant among these plan provisions were the following:

For plans established after December 31, 2001, qualifying small employers who adopt a new qualified retirement plan will be eligible for an annual tax credit of 50% of administrative costs up to \$1000 for the first three years of the new plan. The credit will be unavailable to any employer that maintained a plan covering substantially the same employees during the previous three years.

The IRS user fee for an “IRS determination letter” requested during the first five years of a plan’s existence by an employer with 100 or fewer employees will be waived.

In the early 1980s, top-heavy rules were introduced to the law. Top-heavy rules are complicated tests used to determine whether “key employees” are receiving an excessive proportion of plan benefits. They primarily impact the small employer, and the immediate effect of their introduction was the termination of many small employer plans. The May legislation introduced substantial easing of the top-heavy rules.

The maximum benefit that can be provided to a defined benefit plan participant has been greatly increased. Two code revisions were principally responsible for this outcome; (1) the maximum “annual benefit that can be provided is the lesser of the three-year high

average compensation or \$160,000. The dollar limit prior to May 2001 was \$140,000; (2) the new law provides for an actuarial reduction of these benefits only when they begin prior to age 62. Prior to May 2001, the age applicable to the actuarial limitation of benefits was 65. The impact of these two revisions on deductible plan funding has, likewise, been sizable, in some instances increasing by as much as fifty percent. A new type of defined benefit plan, called the cash benefit plan, offers flexibility in design and higher benefits than traditional defined benefit pension plans.

Beginning in 2002, the defined contribution plan permitting the largest deduction is the 401(K). It permits a deduction of 25% of gross compensation plus all salary deferrals. Permissible contribution allocations (employer and employee) are also increased to the lesser of 100% of compensation, or \$40,000. Beginning in 2002, any employee who is over age 50 may make an additional \$1000 catch-up contribution that is not subject to any other plan limitation.

For Simple-IRA plan participants, the 2002 contribution limit has been increased to \$7000. Plan participants age 50 and older can take advantage of the new “catch-up” provisions by making an additional dollar contribution. Those catch-up contributions increase from \$500 in 2002 in stages to \$2500 in 2006.

In 2002, the annual limit for Traditional and Roth IRA contributions increases to \$3000. The limit will continue to increase annually until 2008, when it reaches \$5000. The catch-up provisions for those over age 50 also apply to Traditional and Roth IRAs.

ESTATE PLANNING ISSUES: The phase-in of estate tax changes makes it particularly difficult for attorneys to draft estate planning documents that can be relied upon for extended time periods. Some of the more important changes are summarized below:

Estate Tax exemption amount increased:

\$1 million	(2002-2003)
\$1.5 million	(2004-2005)
\$2 million	(2006-2008)
\$3.5 million	(2009)
Estate Tax Repealed	(2010)
Estate Tax Returns	(2011)

Estate Tax rates reduced:

5% surtax (which phases out the benefit of the graduated rates for large estates) and rates over 50% are repealed effective 2002.

Further reductions:

2003: top rate is 49%
2004: top rate is 48%
2005: top rate is 47%
2006: top rate is 46%
2007-2009: top rate is 45%
2010: no more estate tax
2011: top rate is 50% plus surtax.

Reduction of state death tax credit:

Each year starting in 2002 until complete repeal in 2005, the state Death tax **credit** is reduced by 25%. In 2005 it is **replaced** by a **deduction** for death taxes actually paid. The repeal of the state death tax credit will eliminate an important element of state funding, as many states have enacted a death tax equal to the maximum federal death tax credit. The repeal of the federal death tax credit is apt to result in states rewriting or increasing their state death tax.

Phasing in of estate tax provisions results in Congress revisiting these changes in each succeeding session. The result is that these revisions contain a higher than ordinary degree of uncertainty. Few believe that the revisions will remain intact without amendment until 2011.

Along with these estate tax revisions, it is important for planning purposes to consider changes in associated sections:

Gift Tax:

The gift tax will be raised to \$1 million effective 2002 and thereafter; it is not indexed. Starting in 2010, the top gift tax rate is reduced to 35%.

Generation Skipping Transfer Tax:

Effective 2010, this tax is repealed. Effective 2001, there will be an automatic allocation of The Generation Skipping Exemption. For it not to apply, it is necessary to elect out.

Carry-Over Basis:

Upon repeal of the estate tax in 2011, the carry-over basis will ordinarily remain only for the first million dollars of estate assets. The rest of the estate's assets will ordinarily be subject to carry-over basis.

Need to Review Estate Planning Documentation:

Anyone having an estate valued in excess of \$600,000 (that until recently was considered a taxable estate) should have his or her estate planning documentation (wills, trusts, retirement plan and insurance policy beneficiary provisions) reviewed. Traditionally, these documents contained formularized provisions dependent on old law for their appropriate operation. With the new law now operative and subject to automatic change, some real disasters may occur. One scenario that will repeat frequently may have the spouse completely or partially disinherited. What is anticipated happening to the spouse could as easily occur with any favored beneficiary. Don't let this happen to you!

September 11, 2001:

Much had transpired in the world of financial planning in 2001 prior to the World Trade Center Attacks.

When these attacks were occasioned in September, they did not initiate the downward spiral of our markets. Our markets had been down for over a year when the terrorists hit; the immediate market reaction was a significant drop followed by the best market quarter in 2001.

Largely overlooked with these attacks was that they were not the first, nor even the first on our soil. The World Trade Center had been attacked by similar terrorists in 1993; TWA 800 was shot down off Long Island in 1998 (just check the websites for TWA 800 should there remain any question); the same parties responsible for the recent World Trade Center attacks have claimed responsibility for the attack on the USS Cole. But with these attacks, our political, religious, and patriotic leaders galvanized the country into action. We would no longer ignore what was happening and concentrate on the economy of the present. We instead were made aware of the long-term threat and determined to make the necessary sacrifices to protect ourselves, our standard of living and our economy.

The enemy's action was taken as an act of war on the United States. Our President stated what to many might appear obvious: that the war would last for years and be quite difficult. The enemy would be targeting the economic system and the morale of the American people. It would be a war of attrition, not of manpower and armament, but of will.

Would we have the staying power, the commitment to our way of life or would the Will of Allah and their religious dedication eventually succeed. It is still too early to tell. Initial returns are unclear.

Our people have unified at home. We have a shaky international coalition of over 100 nations that has been declared against the Terrorists. We have marked improvement in our relationship with Russia. Much of the Taliban has been cleared from Afghanistan. We have brought, or are about to bring, important members of the Taliban leadership to

confinement in Cuba. Radical terrorists, such as the Iranians and Quadafi in Libya, have muted their belligerence while Mustafa in Pakistan and the leaders of Turkey have provided needed public positive assistance.

But there are also terrorist victories. The attack on the Indian Parliament and the shaky situation in Kashmir have led to heightened tensions between India and Pakistan, now at the verge of nuclear war. The Middle East Conflict also threatens to move toward all out war. Little diplomacy can be achieved, nor does Israel appear to want to move toward peace. Significant demonstrations for the enemy have occurred in areas of South America and the Argentine bankruptcy makes the economy of that part of the world even more unsettled. The Europeans object strenuously to our treatment of confinees in Cuba. Each of these troubled spots threatens the cohesion of our alliance. They have incalculable adverse impact on our world integrated market place and overall standards of living. Taken together they constitute significant victories for the Terrorist cause.

The terrorists can also look with pleasure to a number of dislocations within our domestic economy. The airline industry is in a shambles; there are significant questions as to whether major carriers such as United, Northwest, US AIR, or even American will survive. The vacation industry is also moribund; those spectacular vacation fares you have been offered are merely signs that someone in our economy is hurting. The cost of preserving our domestic security has increased markedly. Our supply lines for raw materials, energy, parts, and fabrics originated in or near the trouble spots of the world are now far from dependable and have hurt business. This hurts not only the manufacturer who requires the material or part to complete his end product, but the next party who may depend on that manufacturer to complete his own good. It hurts the shipping company that has to carry the good to market, and it hurts the seller. When one sector of the manufacturing process is unable to produce, it starts a chain reaction.

These burdens being carried by business have provided uncertainties in our overall markets. Last year, the S&P 500 closed up or down by at least 1% from its previous close 42% of its trading days. That volatility evidenced fear in the marketplace. That volatility was most pronounced immediately after the World Trade Center Attacks. Most people anticipate another attack.

At the end of the year, roughly 2.36 trillion dollars had accumulated in money market funds. If committed to the market this cash could ignite a most significant rally. Most economists anticipate a stock market rally in 2002.

Immediately after the World Trade Center Attacks and again at the end of October, this office published its perspective on the market. Those market perspectives remain on our website at www.rjf.com/tip. The risk of market loss may be somewhat less at this market juncture than it was in October. But for the foreseeable future, there is much greater risk in the stock market than what was assumed prior to September 11. Caution is the appropriate watch word for whatever action is to be taken.

Action needs to be taken. Money market funds are providing us with an average return of 1.83%. Savings accounts are providing the average yield of 1.12%. The average yield on a six-month CD is 2.76%. The one-year average is 2.94% and the five-year comes in at 4.25%. Returns on fixed income instruments are shown in the table that follows:

Treasury Yields

Term	1/28/02	1/25/02
3 mos	1.71	1.54
6 mos	1.82	1.78
1 yr	2.20	2.15
2 yr	3.17	3.22
5 yr	4.40	4.46
10 yr	5.07	5.11
30 yr	5.46	5.51

Discount Rate	1.25%
Prime Rate	4.75%
Fed Funds	1.75%

Way back at the beginning of this article we provided a table that illustrated how much it would be necessary for you to accumulate in order to provide a cash flow of \$10,000 per year for *X* years. Have you accumulated what you need as a fund for the education of your children, for your personal needs, for retirement, or as a sum to be passed on to your survivors? Most of us have not. Can that sum be obtained by keeping your money in cash equivalents? If so, then perhaps that's where you will want to maintain your money. Circumstances do not dictate your decision.

For most of us there will be a need to carefully measure what we will need for education, personal goals, retirement living, and to pass to our survivors. We need to employ as tax efficient and investment wise, a plan for the future as can be designed. The design and implementation of such a plan will be demanding. You will not want to go forward without the assistance of experts who understand the tax law in its complexity and how it best is integrated with the complicated world of investment to further our own particular goals.

One major component of what will be applied to your investment planning will fall under the rubric of TIME HORIZON Planning. Thus, one of the major investment firms has spent considerably in time and money looking to the historic returns provided over measured time periods for components from the investment spectrum. From this study, that firm has been able to model appropriate generic investment allocations for differing

time periods and, further to provide advisory models as to how these accumulations might best be liquidated in satisfying specific time period goals. We have been impressed with how well these studies integrate with the legal component of estate, retirement, educational planning, and how the asset allocations recommended provide safety nets to our planning.

Further needed to implement an appropriate financial planning for our clients has been an in depth evaluation designed to measure the comparative performance and volatility of specific manager portfolios that fit into the time slots determined by the investment firm just reviewed for TIME HORIZON planning. That evaluation has been ongoing here for some period of time. Frankly, although some growth managers have been included among our final selections, the majority of the managed accounts surviving our study have had a value orientation.

The legislation completed in May indicates that the government well recognizes the various components of your financial planning. It has provided the structure for education planning, retirement planning, and succession planning. That structure accommodates well with our time horizon model. As a member of the Group who now sees the legislative component of his work moving forward and as one who has followed the TIME HORIZON study in his investment business, I am struck with how well the two efforts work together. I find more rewarding the time spent in implementing the composite results of these two theories. In the future, more time will be spent in such closely integrated planning as a percentage of the total time spent on your account.

For a number of years, I have been providing investment advisory and business consulting services to clients in addition to transaction based brokerage services. These services have been performed without charge to clients and have included cash flow analyses, high level financial planning, portfolio management and retirement/educational counseling. In addition, year-end reconciliations and bookkeeping related services have been provided to some clients without charge. Unfortunately, the economy and the considerable time spent providing these services have made it necessary that I charge for the services in the future. I have decided to charge what I believe to be substantially less than the prevailing hourly rate for individuals with comparable experience, while at the same time to fairly reimburse myself for the time involved. I have determined to charge a rate of \$195 per hour or proportionate fraction thereof for these services beginning January 1, 2002. I am informed that fees for similar services in the Boston area are upwards of \$300 or more per hour, so the fees to be charged by me are believed to be highly competitive. A detailed list of charges fees will be mailed .

My legal counsel has advised me that the Registered Investment Advisory form INV-ADV will require amendment to reflect the change in the method of calculation of advisory fees charged. In the next few weeks, I will be making the necessary amendments and I will invite you to request a copy of Part II of amended form ADV. In the meantime, I wanted to inform you of the amended form ADV and the change in fees to be charged.