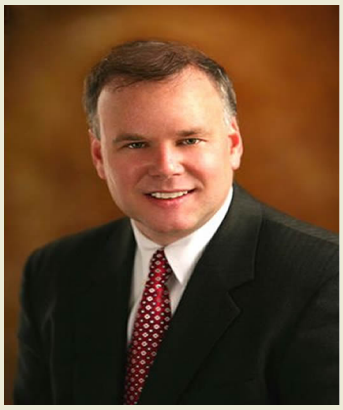

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Inflation or Deflation: Watching for Warning Signs

There's been much debate in investing circles over the last year about whether inflation or deflation represents a more likely threat to the future of the U.S. economy. With a recovery that's still tentative compared to previous recessions, measures designed to stimulate the economy or cut spending to rein in the budget deficit provoke warnings about their potential to create one or the other.

The case for inflation

As the economy has begun to recover, worries about the potential for future inflation have become widespread. The Fed has undertaken extraordinary measures to make sure there is plenty of money in circulation, but some experts worry that the increased money supply will eventually cut the dollar's purchasing power, especially if interest rates are kept at historically low levels for too long. They cite the easy availability of money as contributing to the late-1990s tech bubble and the mid-2000s housing bubble, and fear that another could be on the way.

The Federal Reserve Board's monetary policy committee maintains that inflation currently is too weak to support normal economic growth, let alone launch an inflationary spiral. However, those who see inflation in our future watch for warning signs such as increased Treasury yields, particularly on longer-term bonds. Higher yields when bonds are auctioned suggest that investors are increasingly wary of tying up their money for long periods at a fixed interest rate if they feel that inflation is going to erode the buying power of those fixed payments over time. Wholesale prices also are watched closely; higher prices at the wholesale level can be a precursor of higher prices at retail (that is, if retailers are able to pass those costs along to buyers, which is not always the case).

The case for deflation

At first blush, the falling prices that characterize deflation don't sound like such a bad thing. Who wouldn't like to be able to buy things for less than they cost now, especially when times are tough? The problem is that those falling prices can harm the economy in several ways, as Americans were reminded during the recent recession. When prices are dropping, people tend to postpone purchases, hoping to pay less in the future (consider what's happened with real estate since 2007). Delayed spending puts pressure on corporate profit margins and companies tend to cut spending themselves, creating financial difficulties for companies that rely on business spending. Cutbacks begin to ripple through the economy.

Deflation typically affects not only prices but wages; scarce jobs can lead to pay cuts even for those who stay employed. And lower incomes can start a new round of cost-cutting by both consumers and business. If this process sounds familiar, it's because for much of 2009, the U.S. experienced negative annual inflation rates for the first time since 1955.

Though consumers have loosened their purse strings in recent months, deflationistas argue that if another financial crisis were to reduce credit availability, or if high ongoing unemployment once again begins to weigh on consumers' willingness and ability to spend, the threat of deflation could return. Those concerned about the possibility of a new round of deflation at some point keep an eye on consumer spending, the state of the credit and housing markets, and the stability of banks and other financial institutions.

Seeing shades of gray

Inflation and deflation aren't necessarily an either-or proposition. It's possible to have inflation in some areas and deflation in others; anyone who has watched food prices or health-care costs increase while their paycheck stayed the same and the value of their house declined can vouch for that.

From an investing standpoint, inflation isn't black-and-white, either. Some industries and asset classes benefit from inflationary forces, while companies that are highly dependent on both commodity prices and cheap labor can be more challenged by rising prices.

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Estate Tax Exemption Is Portable (for Now)

These Deferred Annuity Mistakes Can Be Taxing

Can the IRS waive the 60-day IRA rollover deadline?

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Estate Tax Exemption Is Portable (for Now)

To use the exemption portability, the first spouse to die must elect to use portability on his or her estate tax return. An estate tax return must be filed by the first spouse to die to use portability even if the return is not otherwise required to be filed.

Many states have state estate tax exemptions that are less than the federal estate tax exemption. So, while your surviving spouse might not be subject to federal estate tax upon your passing, your surviving spouse may have to pay significant state estate tax if you rely solely on the federal exemption portability.

Recent legislation introduced a new, but perhaps temporary, estate planning concept--exemption "portability." In short, the estate of a deceased spouse can transfer to the surviving spouse any portion of the federal estate tax exemption that it does not use. The surviving spouse's estate can then add that amount to the exemption it is entitled to, increasing the total amount that can be passed on to heirs tax free. This new feature makes it easier for married couples to minimize the potential impact of estate taxes.

The federal estate tax exemption defined

The federal government imposes a tax on the value of your property when you pass it along to your descendants at your death. Any amount that is passed to a surviving spouse is generally fully deductible. The estate is also allowed to exclude a certain amount that passes on to nonspouse beneficiaries. That amount is called the "basic exclusion amount," which is $5 million in 2011.

How the exemption works for married couples

Prior to the new tax law, if a spouse died without having planned for his or her exemption, the deceased spouse's estate would have passed tax free to the surviving spouse under the unlimited marital deduction (assuming all assets passed to the surviving spouse), and the deceased spouse's exemption was lost or "wasted." The surviving spouse's estate could then only transfer an amount equal to his or her own exemption free from federal estate tax. To solve this dilemma, married couples typically set up what is commonly referred to as a credit shelter trust (aka "bypass" or family trust) that sheltered or preserved the exemption of the first spouse to die.

The following examples illustrate how portability can achieve a similar result without the use of a credit shelter trust.

Example: result without portability

Assume Henry and Wilma are married, have all of their assets jointly titled, and have a net worth of $10 million. Henry dies first, when the federal estate tax exemption is $5 million and there is no portability. Henry's estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his $5 million exemption. Assume that at the time of Wilma's death, the exemption is still $5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth $10 million. With Henry's exemption completely wasted, Wilma can pass on only $5 million free from federal estate tax. Assuming no other variables, Wilma's estate will owe about $1,750,000 in federal estate tax: $10 million estate - $5 million exemption = $5 million taxable estate x 35% estate tax rate = $1,750,000.

Example: result with portability

Assume Henry and Wilma are married, have all of their assets jointly titled, and have a net worth of $10 million. Henry dies first, when the federal estate tax exemption is $5 million and there is portability. As above, Henry's estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his $5 million exemption. Even though Henry's estate owes no tax, Henry's executor files a timely return on which he elects to transfer Henry's unused exemption to Wilma. Assume that at the time of Wilma's subsequent death, the exemption is still $5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth $10 million. Since Wilma has "inherited" Henry's unused exemption, she can pass on the entire $10 million estate free from federal estate tax. Portability of the estate tax exemption saves Henry and Wilma's heirs $1,750,000 in estate tax.

Portability does not eliminate the benefits of credit shelter trusts

Even with portability, there are still tax and nontax considerations that may lead you to use a credit shelter trust, such as:

- The portability feature is in effect for only two years and will expire after 2012, unless Congress enacts further legislation.
- The trust can help protect assets against creditors of the surviving spouse or future beneficiaries (typically children and grandchildren).
- The trust allows the first spouse to die to control the ultimate distribution of his or her assets. For example, in a second marriage situation, one spouse may wish to ensure that any assets remaining after his or her spouse's death pass to his or her children from a previous marriage.
- Appreciation of assets placed in the trust will escape estate taxation in the survivor's estate.
- The portability feature applies only to estate tax; it does not apply to the generation-skipping transfer (GST) tax. Without a trust, any unused GST tax exemption of the first spouse to die is lost.

These Deferred Annuity Mistakes Can Be Taxing

The situations described here relate to deferred annuities. Different tax rules may apply to annuities in the payment stage (annuitization).

The tax treatment of nonqualified deferred annuities (annuities that are not part of a tax-qualified plan such as an IRA or 401(k)) appears to be fairly clear-cut:

- A distribution that represents a return of your investment in the contract is not taxed
- Earnings aren't taxed until they're withdrawn
- Earnings are taxed as ordinary income and not capital gains, and
- A distribution of earnings taken before age 59½ is subject to a 10% tax penalty unless an exception applies

Simple, right? Yes--except for those particular circumstances that trigger unexpected tax consequences.

Ownership by a "non-natural entity"

"Non-natural entity" is tax speak meaning the annuity owner is not a human being, but is an entity (e.g., trust, partnership, corporation). This creates a situation where the annuity is not treated as a tax-deferred annuity, so any earnings will be taxed to the annuity owner/entity as ordinary income during the current year--even if the earnings haven't been distributed.

There are some exceptions to this rule. It doesn't apply to immediate annuities or those considered qualified funding assets (e.g., annuities held for periodic payments due to personal injury settlements). Also, the annuity may not lose its tax-deferred status if the non-natural entity/owner is acting as the agent for a natural person. For example, ownership of the annuity by the estate of a deceased annuity owner, or the trustee of an IRA or qualified plan, will not, in and of itself, remove its tax-deferred status.

Certain revocable (grantor) trusts may also be the annuity owner without negating the annuity's tax-deferred status, as long as all of the trust beneficiaries are natural persons. However, if an irrevocable (non-grantor) trust, such as a credit shelter trust, is the annuity owner, distributions of earnings from the annuity may be subject to an additional 10% tax penalty. That's because exceptions to this penalty that are available to a person/annuity owner don't apply to a non-natural entity. For example, a non-natural entity can't claim to be over age 59½, nor can it be disabled from work.

Gifting an annuity contract

If you make a gift of an annuity you own, special income tax rules apply. If you owned the annuity for some time before making the gift, you are subject to a tax on the difference between the value of the annuity (its cash surrender value) and the amount you have invested in the contract (your premiums). You would have to claim the income in the tax year you make the gift. This rule applies to gifts of annuities to charities and charitable remainder trusts as well. A gift of an annuity contract between spouses generally does not trigger this tax, however.

A trust as your annuity beneficiary

Revocable living trusts are a common estate planning tool. Often, an annuity owner/trustor will name the trust as beneficiary of an annuity. However, if you're survived by a spouse, naming the trust as the annuity beneficiary may remove some settlement options your spouse would otherwise have.

Generally, a surviving spouse named as beneficiary of a deferred annuity has four options available: (1) take the full death benefit in a lump sum (the earnings will be treated as taxable income at the time the benefit is paid); (2) take the annuity proceeds over a period of five years; (3) elect to receive the annuity payments over a period of time not to exceed his or her lifetime (with the last two options, each payment is part nontaxable return of investment and part taxable earnings); or (4) the surviving spouse may also have the unique option of becoming the new owner of the inherited annuity, in which case the annuity can continue in deferral (the spouse doesn't have to take any payments).

However, by naming the trust as beneficiary instead of your spouse, you'd be eliminating the last two options for your spouse--even if your spouse is the beneficiary of the trust. With the trust as beneficiary, the annuity proceeds would have to be paid in a lump sum or over five years following your death. If your annuity has significant earnings, those earnings would be taxed upon distribution, even if your spouse neither needs nor wants the proceeds.

Using an annuity as collateral for a loan

Using your deferred annuity as collateral for a loan may result in the unwanted realization of taxable income to you. For instance, say the basis (premiums paid) in your annuity is $100,000 and it's now worth $150,000. If you use this annuity as collateral for a loan, the collateral assignment is treated like a distribution and all of the gain (i.e., $50,000) will be taxable to you as ordinary income.

The income tax rules for deferred annuities can be tricky, so before making any ownership or beneficiary designation changes, consult your financial or tax professional.

Ask the Experts

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Can the IRS waive the 60-day IRA rollover deadline?

If you take a distribution from your IRA intending to make a 60-day rollover, but for some reason the funds don't get to the new IRA trustee in time, the tax impact can be devastating. In general, the rollover is invalid, the distribution becomes a taxable event, and you're treated as having made a regular, instead of a rollover, contribution to the new IRA. But all may not be lost. The 60-day requirement can be automatically waived in some cases, and the IRS has the discretion to waive the rule in others. The 60-day requirement is automatically waived if *all* of the following apply:

- The financial institution receives the funds on your behalf before the end of the 60-day rollover period
- You followed all the procedures set by the financial institution for depositing funds into an IRA within the 60-day period (including giving instructions to deposit the funds into an IRA)
- The funds are not deposited into an IRA within the 60-day rollover period solely because of an error on the part of the financial institution
- The funds are deposited within 1 year from the beginning of the 60-day rollover period
- It would have been a valid rollover if the financial institution had deposited the funds as instructed

If you don't qualify for an automatic waiver, you can apply to the IRS for a discretionary waiver. The IRS may waive the 60-day requirement where failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control. The IRS will consider all relevant facts and circumstances, including:

- Whether errors were made by the financial institution (in addition to those described under automatic waiver, above)
- Whether you were unable to complete the rollover on a timely basis due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error
- Whether you used the amount distributed
- How much time has passed since the date of distribution

What is the IRA one-rollover-per-year rule?

The one-rollover-per-year rule is a little known provision that says you can only make one rollover from a particular IRA to any other IRA in any 12-month period. A violation of the rule can have serious adverse tax consequences. Luckily, it's a problem that's very easy to avoid.

Here's how the IRS states the rule: "If you make a tax-free rollover of any part of a distribution from an IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over to an IRA."

This is best understood with an example. Assume you have three IRAs, A, B, and C. On January 1, 2011, you receive a distribution from IRA A and, within 60 days, you roll that distribution over to IRA B. The one-rollover-per-year rule says that any other distribution from IRA A that you receive before January 1, 2012, can't be rolled over. Similarly, any distribution from IRA B that you receive before January 1, 2012, can't be rolled over. You can, however, receive a distribution from IRA C and roll it over to any other IRA without restriction.

What happens if you violate the rule? The disallowed rollover is taxed as a distribution to you; if you're not age 59½, the additional 10% early distribution penalty may apply; you're treated as having made a regular, rather than rollover, contribution to the receiving IRA, so a 6% excess contribution penalty may apply; and you may be subject to additional penalties if you fail to report the "rollover" as a distribution on your income tax return.

So how do you avoid the problem? It's easy. Use direct transfers instead of 60-day rollovers. The rule doesn't apply when IRA funds are transferred directly from one trustee to another trustee (you never receive the funds). The rule also doesn't apply to conversions of traditional IRAs to Roth IRAs. So you can make as many trustee-to-trustee transfers, or Roth IRA conversions, as you like in any year--the one-rollover-per-year rule will not apply.