

# Arbor Capital Management Strategic Investor

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## Take A Bite Out Of Inheritance Taxes

There's more to it than just writing a will.

By Suze Orman

**W**hy is it that, even as the new century approaches, far too many of us are stuck in the old century when it comes to our financial futures and the futures of those we love? A perfect example is estate-planning. After working 40 hours a week for a lifetime, don't you want your hard-earned money eventually to go to your loved ones and not to the tax collector?

If you're thinking that estate-planning is only a millionaire's problem, then you're denying the possibility that, as you annually build up assets, protecting them for your loved ones to inherit could become *your*

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**If you are married, you can set up a credit-shelter trust and shelter double the federal estate tax-exemption amount, so that your beneficiaries can inherit double the permitted amount, tax-free.**

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problem too. When you add your assets—real estate, 401(k) or other retirement plans, plus money you might inherit and other investments—and anticipate how they might grow in the next few years, you already may have far more than you think.

This year, estate or inheritance taxes become major concerns once your net worth totals more than \$650,000. That's the current amount each of us can pass on to our beneficiaries free of federal estate taxes. (Some states levy their own inheritance taxes.)

An exception to this is passing money from

spouse to spouse, because spouses (so long as the survivor is a U.S. citizen) can inherit an *unlimited* amount from each other, free of federal estate taxes.

For beneficiaries other than spouses, the inheritance in excess of \$650,000 will be taxed by the IRS at a graduated rate beginning at 37% and rising to 55% for an estate valued at \$3 million or more. If you are married, however, you can set up a **credit-shelter trust** and shelter *double* the amount of the federal estate-tax exemption—so your beneficiaries can inherit *double* the permitted amount, or \$1.3 million, without any concern about federal estate taxes. (The amount of the exemption is scheduled to keep rising, so that in the year 2000 it will be \$675,000, and by 2006 it will be up to \$1 million.)

A credit-shelter trust must be set up while both spouses are alive and married. They should divide the assets they individually own. When one spouse dies, rather than his or her assets passing to the surviving spouse, the assets go into an **irrevocable trust**. (In this type of trust, once you name an heir, you can't change it) Let's look at how two families handled their estates:

- After a happy and comfortable life, first Mr. Smith and eventually his wife died, leaving \$1 million to their daughter, Rachel.
- After a happy and comfortable life, first Mr. Jones and eventually his wife died, leaving \$1 million to their daughter, Charlotte. But Charlotte inherited only \$828,200. While still a considerable sum of money, it was much less than the \$1 million Rachel inherited, and all because of the way their parents set up their respective estates.

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Rachel's parents had taken into account the estate or inheritance-tax consequences and established a credit-shelter trust on their daughter's behalf. (It's also known as a **tax-planning trust**, an **AB trust** or a **marital trust**.)

When Rachel's father died, all the money on his side went into an irrevocable trust for his wife—rather than to his wife outright—but the eventual beneficiary of that trust was Rachel. By doing this, when Rachel's mother died, the money she left to Rachel that was on her side received a credit amount of \$650,000 for estate-tax purposes, but so did the money that was in the irrevocable trust. In essence, she could have passed down twice the individual shelter amount of \$650,000, or \$1.3 million, without federal estate taxes in 1999.

Were there restrictions on this money after Rachel's dad died? Only minor ones. Until her death, Rachel's mother had full management over her husband's "half" and full access to it—but only after she spent what the government considered her own half (or if certain predetermined conditions had been set up by the trust). She also had to file separate tax returns each year—one for the credit trust and one for herself. Not much trouble to ensure that her daughter inherited the full estate.

Also, as the credit-shelter amount increases, it continues to apply to your trust even if you set it up in 1999. When 2007 comes, with increases in the federal estate-tax exemptions, your trust will be able to shelter \$2 million.

Now let's see how Charlotte's parents handled their estate. Although they had the same intentions as Rachel's mother and father, Charlotte's parents passed down their estate to their daughter via simple wills, which left everything to the surviving spouse. When Charlotte's mother died with the \$1 million in her name, the most she could leave her daughter federal estate-tax free was \$650,000.

Since her parents didn't segregate each other's half of the estate under a protective trust, when her mother died, Charlotte only was able to inherit her credit-shelter amount, or \$650,000, free of federal estate taxes. That left \$350,000 unprotected. Unsheltered by a trust, it was taxed at the 37% estate-tax rate, subtracting \$129,500 from the estate. That left her with \$870,500.

But because the money was passed down via a will, Charlotte incurred another cost—probate, the court process by which a will is first authenticated and then its assets are distributed. The process of probate (which you bypass with a credit-shelter trust such as Rachel's parents had) is costly. Though it varies, I'll assume hers cost \$42,300, which is what she would have paid in California. Subtract that from the \$870,500, and you get the total of her inheritance: \$828,200, or \$171,800 less than Rachel's \$1 million.

Bottom line: Do everything you can to protect your money for your beneficiaries.

*Suze Orman is the author of "The Courage To Be Rich: Creating a Life of Material and Spiritual Abundance," to be published in March by Riverhead.*

### What If You Inherit Real Estate?

If Charlotte had inherited the \$2 million in real estate, would she have been better off? No. In fact, she would have fared even worse.

That's because when you inherit real estate over the permitted amount, you have nine months after the date of death before estate taxes are due. If Charlotte can't pay that \$129,500 in estate taxes by then, or sell the property to pay the taxes, she faces a big problem. And even if the government grants a one-year-extension, the IRS starts calculating interest due from the nine-month date, so Charlotte would have to pay estate taxes plus the interest from the IRS.

Therefore, if you plan to leave property to your loved ones, you should set up a credit-shelter trust as soon as possible, so that your heirs will not have to pay probate costs or experience any delay in receiving their inheritance.

## REITs: Investing in Real Estate with Liquidity and Diversification

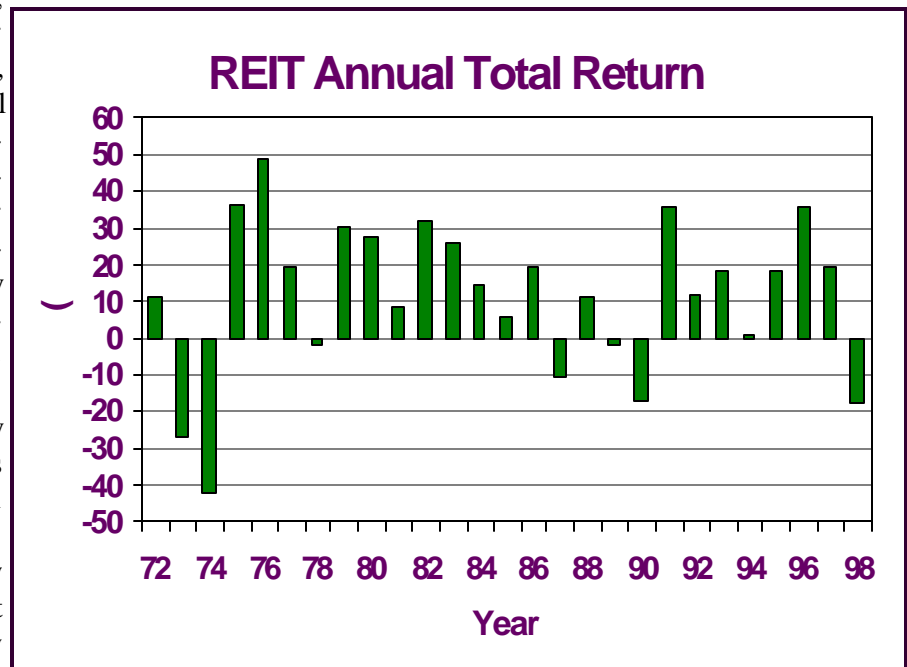
**C**reated in 1960 by Congress, publicly traded Real Estate Investment Trusts (REITs) have come of age in the 1990's. So what exactly is a REIT? REITs are corporations specifically dedicated to owning and operating income-producing real estate, such as apartment complexes, office buildings, shopping centers, hotels and industrial related properties (most REITs specialize in one or two areas). REITs are different from other corporations in that each year they are required by law to pay out virtually all of their operating income to shareholders. In return for complying with this requirement, REITs avoid almost all traditional corporate income taxes. This favorable taxation treatment allows REITs to generate income for their investors with only one level of taxation, unlike other companies that pay taxes first and then kick out dividends to shareholders who may be taxed again.

In the 1990's the REIT industry has grown by leaps and bounds as massive amounts of privately held real estate has transferred to the publicly owned REIT industry. By combining a diversified investment in real estate assets, all the liquidity of a publicly traded stock and a

stable stream of dividend income, REITs have become mainstream investments that are a solid addition to a diversified investment portfolio.

Although in 1998 the sector suffered one of its worst performance years in history, REITs have yielded very attractive total returns to investors over the years. As the chart on this page shows, REITs have had their up years and down years like many investments. Overall though, they have had a lot more upside than downside. In fact, since 1972 they have achieved a 10% compound annual growth rate (CAGR). Much of this total return comes from the

healthy dividends REITs pay out. (After the significant price drops in REIT shares in 1998, the average REIT is now yielding around 7.5%). The remaining portion of the total return comes from price appreciation in REIT stock prices, which over the longer-term is driven by growth in Funds From Operations (FFO). FFO is basically net income with amortization and depreciation charges added back. FFO is utilized instead of net income to evaluate REITs because it gives a clearer picture of the cash a REIT is actually



generating on an ongoing basis. In the past, REITs have consistently enhanced shareholder return by growing FFO through the acquisition of more properties and increases in rent rates. Because REITs are essentially real estate based investments, another facet of the REIT investment story are low correlations to the returns of the general equity markets. Since REITs rarely follow the near-term path of other equities, they can both diversify and lower the overall volatility of your portfolio.

There were many reasons 1998 was a down year for REITs. The decline in prices began early in the

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year due to industry concerns about the risks of overbuilding and the possibility of economic downturn in the U.S. As mid-year arrived, a severe credit crunch, brought on by fears of worldwide economic calamity curbed the expansion plans of almost every REIT, contributed to the the dive in prices. In addition, there was a large amount of investor confusion caused by a legislative change that took away the

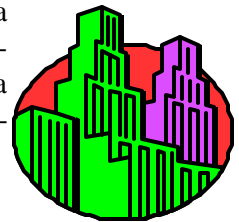
## Roth IRA Refresher

After maximizing your contributions to the company retirement plan, a Roth IRA is the next best place to pursue tax-free growth of your investment dollars. Roth IRAs allow a maximum annual contribution of \$2,000 for single persons earning up to \$95,000 and a combined \$4,000 contribution is allowed for married couples, filing jointly, earning as much as \$150,000 (other limitations apply for other filing options). You may recall that although Roth IRAs don't offer a front-end tax deduction on contributions, they allow tax-free growth of the invested assets and are totally exempt from taxes on withdrawals after age 59½. In general, if you meet the eligibility requirements, the Roth IRA is a useful addition to your long-term wealth accumulation plan as it offers lifelong tax-free treatment of your investments.

favorable tax treatment for what are known as paired-share REITs. But this change only affected a handful of REITs, mainly hotel REITs, that had basically evolved into companies making most of their money from services rather than from real estate. On top of all this, frustrated investors began withdrawing money from REIT mutual funds, further increasing selling pressure on REITs by forcing the funds to liquidate shares of REITs to cover redemptions.

Despite the drastic downturn in price, operationally REITs really did not have that dreary of a year. In fact, rents were stable throughout the industry and FFO increased for the vast majority of companies. In 1999, FFO is forecasted to grow another 11% as many of the potential problems for the industry have failed to evolve. Fears of overbuilding, which were mainly focused on the office sector, appear to have been overblown as occupancy in this sector remains healthily above 90%. Also, current building rates in this sector are only half what they were in the late 80's. The U.S. economy and real estate prices have remained stable and most importantly the credit crunch that curbed REIT expansion plans in 1998 has abated.

The price declines of 1998 have created a very attractive buying opportunity in the REIT sector. The average REIT is now selling below the value of the actual real estate they own and is trading at only 9.8 times 1998 FFO. In trying to explain the downtrodden state of the industry, REIT analyst Jeffrey Donnelly lamented in a recent article that, "REITs are a dull story in a very sexy market." Dull or not, from these depressed levels, we expect REIT companies to deliver significant share price appreciation, in addition to their high dividend yields. A combination we expect to yield a substantial total return on REIT investments going forward. So, while not a "sexy" investment, REITs are certainly an attractive addition to a diversified portfolio for conservative and moderate investors.



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