

POSSIBILITIES

FINANCIAL INSIGHTS FOR INDIVIDUALS AND BUSINESSES

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Estate Tax Exemption Is Portable (For Now)

Recent legislation introduced a new, but perhaps temporary, estate planning concept—“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 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 (a.k.a. “bypass” or family trust) that sheltered or preserved the exemption of the first spouse to die.

The following example illustrates 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 percent, 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 \$1.75 million in federal estate tax: \$10 million estate - \$5 million exemption = \$5 million taxable estate x 35 percent estate tax rate = \$1.75 million.

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



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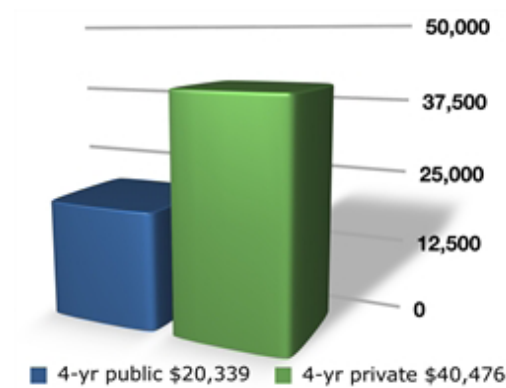
Saving for College

There's no denying the benefits of a college education: the ability to compete in today's competitive job market, increased earning power, and expanded horizons. But these advantages come at a price—college is expensive. And yet, year after year, thousands of students graduate from college. So, how do they do it?

Many families finance a college education with help from student loans and other types of financial aid, such as grants and work-study, private loans, current income, gifts from grandparents, and other creative cost-cutting measures. But savings are the cornerstone of any successful college financing plan.

College Costs Keep Climbing

It's important to start a college fund as soon as possible, because next to buying a home, a college education might be the biggest purchase you ever make. According to the College Board, for the 2010/2011 school year, the average cost of one year at a four-year public college is \$20,339, while the average cost for one year at a four-year private college is \$40,476.



Though no one can predict exactly what college might cost in 5, 10 or 15 years, annual price increases in the range of 5 to 8 percent would certainly be in keeping with historical trends. The following chart can give you an idea of what future costs might be, based on the most recent cost data from the College Board and an assumed annual college inflation rate of 5 percent.

Year	4-yr public	4-yr private
2010/11	\$20,339	\$40,476
2011/12	\$21,356	\$42,500
2012/13	\$22,424	\$44,625
2013/14	\$23,545	\$46,856
2014/15	\$24,722	\$49,199
2015/16	\$25,959	\$51,659
2016/17	\$27,256	\$54,242
2017/18	\$28,619	\$56,954
2018/19	\$30,050	\$59,801
2019/20	\$31,552	\$62,792
2020/21	\$33,130	\$65,931

Tip: Even though college costs are high, don't worry about saving 100 percent of the total costs. Many families save only a portion of the projected costs—a good rule of thumb is 50 percent—and then use this as a “down payment” on the college tab, similar to the down payment on a home.

Focus on Your Savings

The more you save now, the better off you'll likely be later. A good plan is to start with whatever amount you can afford, and add to it over the years with raises, bonuses, tax refunds, unexpected windfalls, etc. If you invest regularly over time, you may be surprised at how much you can accumulate in your child's college fund.

Monthly Investment	5 years	10 years	15 years
\$100	\$6,977	\$16,388	\$29,082
\$300	\$20,931	\$49,164	\$87,246
\$500	\$34,885	\$81,940	\$145,409

Table assumes an average after-tax return of 6 percent. This is a hypothetical example and is not intended to reflect the actual performance of any investment.

College Savings Options

You're ready to start saving, but where should you put your money? There are several college savings options, but to come out ahead in the college savings game, you should opt for tax-advantaged strategies whenever possible.

529 Plans

529 plans are one of the most popular tax-advantaged college savings options. They include both college savings plans and prepaid tuition plans. With either type of plan, your contributions grow tax deferred and earnings are tax free at the federal level if the money is used for qualified college expenses. States may also offer their own tax advantages.

With a college savings plan, you open an individual investment account and select one or more of the plan's mutual fund portfolios for your contributions.

With a prepaid tuition plan, you purchase tuition credits at today's prices for use at specific colleges in the future—there's no individual investment component. With either type of plan, participation isn't restricted by income, and the lifetime contribution limits are high, especially for college savings plans.

***Note:** Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

Coverdell Education Savings Accounts

A Coverdell education savings account is a tax-advantaged education savings vehicle that lets you contribute up to \$2,000 per year. Your contributions grow tax deferred and earnings are tax-free at the federal level (and most states follow the federal tax treatment) if the money is used for the beneficiary's qualified elementary, secondary or college expenses. You have complete control over the investments you hold in the account, but there are income restrictions on who can participate.

U.S. Savings Bonds

The interest earned on Series EE and Series I saving bonds is exempt from federal income tax if the bond proceeds are used for qualified college expenses. These bonds earn a guaranteed, modest rate of return, and they are easily purchased at most financial institutions or online at www.treasurydirect.gov. However, to qualify for tax-free interest, you must meet income limits and other criteria.

UTMA/UGMA Custodial Accounts

An UTMA/UGMA custodial account is a way for your child to hold assets in his or her own name with you (or another individual) acting as custodian. Assets in the account can then be used to pay for college. All contributions to the

account are irrevocable, and your child will gain control of the account when he or she turns 18 or 21 (depending on state rules). Earnings and capital gains generated by assets in the account are taxed to the child each year.

Under the kiddie tax rules, for children under age 19, and for fulltime students under age 24 who don't earn more than one-half of their support, the first \$950 of earned income is tax free, the next \$950 is taxed at the child's rate, and anything over \$1,900 is taxed at your rate.

A Last Word on Financial Aid

Many families rely on some form of financial aid to pay for college. Loans and work-study jobs must be repaid (either through monetary or work obligations), while grants and scholarships do not.

Most financial aid is based on need, which the federal government and colleges determine primarily by your income, but also by your assets and personal information reported on your aid applications. In recent years, merit aid has been making a comeback, so this can be good news if your child has a special talent or skill.

The bottom line, though, is don't rely too heavily on financial aid. Although it can certainly help cover college costs, student loans make up the largest percentage of the typical aid package. Generally, plan on financial aid covering the following percentage of expenses: loans—up to 50 percent, grants and scholarships—up to 15 percent, work-study—varies. The lesson: the more you focus on your savings now, the less you may need to worry about later.

CONTACT

- Talk to your local Eide Bailly financial advisor
- Call 866.740.4100 for more information



Exchange-Traded Funds: Do They Belong in Your Portfolio?

Exchange-traded funds (ETFs) have become increasingly popular since they were introduced in the United States in the mid-1990s. Their tax efficiencies and relatively low investing costs have attracted investors who like the idea of combining the diversification of mutual funds with the trading flexibility of stocks. ETFs can fill a unique role in your portfolio, but you need to understand just how they work and the differences among the dizzying variety of ETFs now available.

What is an ETF?

Like a mutual fund, an exchange-traded fund pools the money of many investors and purchases a group of securities. Like index mutual funds, most ETFs are passively managed. Instead of having a portfolio manager who uses his or her judgment to select specific stocks, bonds or other securities to buy and sell, both index mutual funds and exchange-traded funds attempt to replicate the performance of a specific index.

However, a mutual fund is priced once a day, when the fund's net asset value is calculated after the market closes. If you buy after that, you will receive the next day's closing price. By contrast, an ETF is priced throughout the day and can be bought on margin or sold short—in other words, it's traded just as a stock is.

How ETFs Invest

Since their inception, most ETFs have invested in stocks or bonds, buying the shares represented in a particular index. For example, an ETF might track the Nasdaq 100, the S&P 500 or a bond index. Other ETFs invest in hard assets—for example, gold bullion. In such cases, a commodity or precious-metals ETF may buy futures contracts or quantities of bullion. With the rapid proliferation of ETFs in recent years, if there's an index, there's a good chance there's an ETF that invests in it.

More and more new indexes are being introduced, many of which cover narrow niches of the market, or use novel rules to choose securities. Many so-called rules-based ETFs are beginning to take on aspects of actively managed funds—

Procs and Cons of Exchange-Traded Funds

Pros

ETFs can be traded throughout the day as price fluctuates.

ETFs can be bought on margin, sold short or traded using stop orders and limit orders, just as stocks can.

ETFs do not have to hold cash or buy and sell securities to meet redemption demands by fund investors.

Annual expenses are often lower, which can be especially important for long-term investors.

Because ETFs typically trade securities infrequently, they have lower annual taxable distributions than a mutual fund.

Cons

Dollar-cost averaging will require paying repeated commissions and will increase investing costs.

If an ETF is organized as a unit investment trust, delays in reinvesting its dividends may hamper returns.

An ETF doesn't necessarily trade at its net asset value, and bid-ask spreads may be wide for thinly traded issues or in volatile markets.

for example, by limiting the percentage of the fund that can be devoted to a single security or industry.

The New Wave of ETFs

New and unique indexes are developing every day. As a result, ETFs that might seem similar—for example, two funds that invest in large-cap stocks—can actually be quite different. Many indexes define which securities are included based on their market capitalization—the number of shares outstanding times the price per share. However, other indexes and the ETFs that mimic them may select or weight securities within the index based on fundamental factors, such as a stock's dividend yield.

Why is weighting important? Because it can affect the impact that individual securities have on the fund's result. For example, an index that is weighted by market cap will be more affected by underperformance at a large-cap company than it would be by an underperforming company with

a smaller market cap. That's because the large-cap company would represent a larger share of the index. However, if the index weighted each security equally, each would have an equal impact on the index's performance.

The Cost Advantages and Tradeoffs of ETFs

As indicated, one of the reasons ETFs have gained ground with investors is because of their low annual expenses. Passive index investing means an ETF doesn't require a portfolio manager or a research staff to select securities; that reduces the fund's overhead. Also, investing in an index means that trades are generally made only when the index itself changes. As a result, the trading costs required by frequent buying and selling of securities in the fund are minimized.

However, don't forget that you'll pay a commission each time you buy or sell ETF shares. That means a one-time lump-sum investment in an ETF will be more cost-effective than dollar-cost averaging, which involves frequent, regular investments over time.

ETFs and Taxes

ETFs can be relatively tax-efficient. Because it trades so infrequently, an ETF typically distributes few capital gains during the year. In the past, there have been times when some investors found themselves paying taxes on capital gains generated by a mutual fund, even though the value of their fund may actually have dropped. Though it's not impossible for an ETF to have capital gains, ETFs generally can minimize the ongoing capital gains taxes you'll pay.

Just how much impact can reducing taxes have over the long term? More than you might think. Even a 1 percent difference in your return can be significant. For example, if you invest \$50,000 and earn an average annual return of 5 percent (compounded monthly), you would have a pretax amount of \$82,350 after 10 years. Even a 1 percent increase in that return would give you \$90,970 at the end of that time. (This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. Actual results will vary.)

Make sure you consider how an ETF's returns will be taxed. Depending on how the fund is organized and what it invests in, returns could be taxed as short-term capital gains, ordinary income, or in the case of gold and silver ETFs, as collectibles; all are taxed at higher rates than long-term capital gains.

What Are Other Reasons Investors Use ETFs?

- To get exposure to a particular industry or sector of the market. Because the minimum investment in an ETF is the cost of a single share, ETFs can be a low-cost way to make a diversified investment in alternative investments, a particular investing style or geographic region.
- To limit losses. Being able to set a stop-loss limit on your ETF shares can help you manage potential losses. A stop-loss order instructs your broker to sell your position if the shares fall to a certain price. If the ETF's price falls, you've minimized your losses. If its price rises over time, you could increase the stop-loss figure accordingly. That lets you pursue potential gains while setting a limit on the amount you can lose.

How to Evaluate an ETF

1. Look at the index it tracks. Understand what the index consists of and what rules it follows in selecting and weighting the securities in it.
2. Look at how long the fund and/or its underlying index have been in existence, and if possible, how both have performed in good times and bad.
3. Look at the fund's expense ratios. The more straightforward its investing strategy, the lower expenses are likely to be. An index using futures contracts is likely to have higher expenses than one that simply replicates the S&P 500.

Your financial professional can help you decide how ETFs might fit your investing strategy.

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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 state estate tax if you rely solely on the federal exemption portability.

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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 percent, 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 \$1.75 million 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 gives the first spouse to die control over 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 will be lost.

Some Technical Information

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 state estate tax if you rely solely on the federal exemption portability.

Exemption portability is available only from the last deceased spouse. It will be lost if the surviving spouse remarries and is widowed again. In other words, if the surviving spouse survives spouse 1, the surviving spouse can use spouse 1's unused exemption even if the surviving spouse marries spouse 2. However, if spouse 2 also predeceases the surviving spouse, the exemption of spouse 1 can no longer be used. However, the surviving spouse can then use the unused exemption of spouse 2. ■

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Divorce and Social Security

Can a Divorced Person Benefit From an Ex-spouse's Social Security Entitlement?

If you're married, it's possible for you to claim Social Security benefits at the appropriate time in one of two ways. You can claim benefits in your own name (if you have been employed and have accumulated enough credits over the years), or you can claim benefits as a dependent (whether or not you ever worked), provided that your spouse satisfied the applicable requirements. In the latter case, you'll probably be entitled to only 50 percent of your spouse's primary insurance amount (PIA)—the benefit that your spouse is entitled at normal retirement age. In certain cases, a divorced party can qualify as a dependent for Social Security purposes. Thus, you may be entitled to 50 percent of your former spouse's benefits. Note: This entitlement doesn't reduce your ex-spouse's benefits by one-half; rather, this merely establishes the amount of money you may collect.

What Requirements Must be Met?

The requirements vary, depending on whether your former spouse is presently of retirement age or has died.

If Ex-spouse is of Retirement Age

In order to qualify for one-half of your ex-spouse's Social Security benefits, all of the following conditions must be met:

- Your ex-spouse is currently entitled to receive Social Security retirement or disability benefits,
- You and your ex-spouse had been married for at least 10 years before the divorce became final,
- You are not currently married,
- You are age 62 or older, and
- You aren't entitled to collect a retirement or disability benefit based on a PIA that equals (or exceeds) one-half of your ex-spouse's PIA.

Note: If you're age 62 or older and you've been divorced for at least two years, you can receive Social Security benefits immediately (based on your former spouse's earnings) regardless of whether that spouse has chosen to retire or has

submitted an application for Social Security benefits. This, of course, is assuming that the other four requirements listed above have been satisfied. However, if you choose to receive benefits at age 62, instead of your normal retirement age, the benefit that you would have received at your normal retirement age will be reduced by at least 25 percent (assuming you don't have a dependent child who's entitled to benefits on the deceased spouse's Social Security record). In other words, if you choose to receive reduced benefits at age 62, you will not be entitled to collect full benefits when you reach your full retirement age.

***Example:** Assume Jack will collect \$750 per month in Social Security benefits when he retires. If he has been married to Joan for at least 10 years before he divorces her, Joan can collect \$375 per month (one-half of Jack's benefit) when she reaches age 65. Naturally, Joan will have the option to take the Social Security benefits she earned in her own name. Obviously, she'll choose the higher figure.*

If you're age 62 or older and caring for a dependent child who is entitled to child's benefits based on a deceased parent's Social Security record, then your benefits won't be reduced currently and will remain unreduced later, after you reach your full retirement age. Bear in mind that you can't receive a spouse's benefits prior to age 62, even if you have a dependent child.

If Ex-spouse Has Died

You may also qualify for Social Security benefits if your former spouse has died. You may qualify if:

- Your ex-spouse was entitled to Social Security benefits,
- You and your ex-spouse had been married to each other for at least 10 years before the divorce was finalized,
- You are age 60 or over (or are between ages 50 and 60 and are disabled),
- You aren't currently married, and
- You aren't entitled to a retirement benefit that is equal to or greater than 100 percent of your deceased spouse's benefit.

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Note that if you meet the above conditions, you will be entitled to full widow's or widower's benefits; that is, you will collect an amount equal to 100 percent of your former spouse's PIA, not merely one-half. However, if you're under full retirement age, your benefits will be reduced for each month you receive benefits under your full retirement age. Benefits at age 60 will be 71.5 percent of your former spouse's PIA. (For more information, see Social Security Survivor's Benefits and the Lump-Sum Death Benefit.)

It's also important to note that a divorced spouse may be entitled to a mother's or father's benefit if caring for the dependent child (under age 16 or disabled) of his or her deceased former spouse. Typically, the amount of a mother or father's benefit is equal to 75 percent of the deceased spouse's PIA. Unlike a spousal benefit, it isn't necessary for the marriage to have lasted 10 years. (For more information, see Social Security.)

How Does Remarriage of the Husband and/or Wife Impact Social Security Benefits?

If your ex-spouse gets remarried and you don't, your Social Security entitlement will

be unaffected. If your ex-spouse is married to a second spouse for at least 10 years and then they get a divorce, you and that second spouse will each be entitled to collect an amount equal to one-half of the former spouse's benefits (assuming that you each meet the requirements set forth above).

If you're the one who remarries, you would then look to your current spouse's PIA in computing your dependent Social Security benefit. However, if you worked for a sufficient period of time, you may be entitled to a larger benefit amount, computed based on your own earnings record.

For more information about the Social Security program and for more detailed treatment of Social Security rules visit www.ssa.gov. ■

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