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White Paper

Marital Deduction and Bypass Planning

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Marital Deduction and Bypass Planning

What is marital deduction and bypass planning?

The unlimited marital deduction allows you to pass an unlimited amount of property to your spouse free from estate or gift tax. Bypass planning is designed to both minimize federal estate taxes for married individuals and allow the surviving spouse to benefit from the family's wealth during his or her continuing life. This can be accomplished by taking full advantage of both the applicable exclusion amount (formerly known as the unified credit), which protects up to \$2 million (in 2008) from estate tax, and the unlimited marital deduction.

Here is a typical scenario where bypass planning was needed:

Example(s): In 2002, Edward died with a taxable estate of \$1 million, which he left to his wife, Sonia. Edward's estate paid no federal estate tax because of the unlimited marital deduction. Edward's estate did not use any of his applicable exclusion amount (\$1 million in 2002). Sonia dies six years later in 2008. Her taxable estate is valued at \$3 million. She leaves her estate to her son Max. Sonia's applicable exclusion amount exempts \$2 million of her property from tax. Sonia's estate owes estate tax on \$1 million. If Edward's applicable exclusion amount had been used at his death, however, Edward and Sonia's combined estates would have owed no estate taxes.

How is it done?

The two-trust plan

At least two separate trusts need to be created by the married couple. The trusts may be funded during the lifetimes of the married couple or at the death of one or both of the individuals. The use of multiple trusts can allow the couple to fully use the applicable exclusion amount of each spouse so that up to \$4 million in assets (in 2008) from their combined estates may be protected from federal estate taxes.

Credit shelter or bypass trust

Typically, the couple will set up one trust, known as a credit shelter or bypass trust, and fund this trust with sufficient assets so that the applicable exclusion amount of the first spouse to die will be fully used. The trust may be funded during the spouses' lifetimes or at the death of the first spouse to die.

The surviving spouse may be given certain rights and limited control over the assets in the credit shelter or bypass trust. That spouse cannot be given absolute control or ownership of the assets in this trust, or the assets would be included in his or her estate when he or she dies. The surviving spouse, however, may receive income for life from the trust, receive distributions of principal at the discretion of the trustee, or may invade the principal of the trust for his or her health, education, support, and

maintenance. If the surviving spouse does not need income from the bypass trust, the income may be accumulated or directed to other persons. The surviving spouse may also be given a testamentary power to appoint all or any of the assets in the bypass trust to a limited class of beneficiaries excluding himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate. The surviving spouse may appoint the assets in the trust to the specified beneficiaries in any proportion that he or she desires. This allows the surviving spouse to appoint the assets to the beneficiaries who need the assets the most. As long as the surviving spouse does not have the power to appoint the assets to himself or herself, to his or her estate, or to his or her creditors, these assets will not be included in his or her taxable estate.

Marital trust

A second trust will usually be created to complement the credit shelter or bypass trust. This second trust is generally called the marital trust. The assets that are not transferred into the bypass trust will fund the marital trust and will be included in the taxable estate of the second spouse to die. However, because of the unlimited marital deduction, the assets that are placed in this trust will not be taxed in the estate of the first spouse to die. The estate tax due on these assets will be postponed until the death of the surviving spouse. The surviving spouse may also use his or her applicable exclusion amount to avoid the estate tax on some or all of the assets in the marital trust.

There are three types of trusts that can be set up as marital trusts:

- **Qualified terminable interest property (QTIP) trust:** In most cases, the marital trust will be set up as a QTIP trust. Under this type of trust, the surviving spouse must receive all income from the trust for his or her lifetime and must have the power to force the trustee to convert nonproductive assets to income-producing assets. However, the first spouse to die can designate in the trust instrument to whom the assets will go when the surviving spouse dies. A QTIP trust is often used when there is concern that the surviving spouse will remarry and transfer assets to the new spouse rather than provide for the children of the marriage or when there are children from a previous marriage for whom the deceased spouse would like to provide in his or her will.
- **Power of appointment trust:** The second type of marital trust is the power of appointment trust. The surviving spouse must be entitled to all income from the trust during his or her continuing life, and he or she must also be given a general power of appointment over the trust assets. Again, all the trust assets will be included in the surviving spouse's estate.
- **Estate trust:** The final type of trust is the estate trust. The surviving spouse need not receive all income from the trust during his or her lifetime, but the trust assets (including any accumulated income) must be payable to the surviving spouse's estate upon his or her death. With an estate trust, the trust corpus does not have to be invested in income-producing assets. For example, the trust may hold undeveloped land or shares in a closely held business.

Example(s): You and your spouse expect to have a taxable estate in excess of \$3 million at the death of the first spouse. You have three children and would like the children to inherit the assets at the death of the surviving spouse. On the advice of your estate planning attorney, you and your spouse have divided the ownership of all the assets so that you each own approximately one-half of them in your own name. You have also set up a bypass trust and a QTIP marital trust. Your attorney puts a provision in your respective wills that upon the death of the first spouse to die, a sufficient amount of that spouse's assets will be transferred into the bypass trust to completely use his or her applicable exclusion amount then available. The remainder is then transferred into a QTIP trust for the benefit of the surviving spouse. The surviving spouse will receive income for life from this trust, and your children will receive the remainder of the trust property when the surviving spouse dies. The QTIP trust will be included in the estate of the surviving spouse. However, he or she can then use his or her applicable exclusion amount to partially or fully offset the federal estate tax due as a result of this inclusion.

With this strategy, you have permitted the surviving spouse to benefit from the family wealth (through lifetime income), minimized the federal estate taxes incurred at each death, and ensured that your children will inherit the bulk of your assets.

What are the advantages of bypass planning?

May allow spouse to have full benefit of total wealth while minimizing taxes

The main advantage of using both a marital and a bypass trust is that this structure allows both spouses to benefit from the family wealth while minimizing the federal estate tax due at the deaths of each spouse. The use of these two trusts is an especially effective estate planning tool in cases where the spouses would like at least some of their assets to go to their children or other beneficiaries. With a QTIP marital trust, although the surviving spouse must receive all income from the trust for life, the grantor of the trust may designate to whom the property in the trust passes on the death of the surviving spouse. The surviving spouse cannot divert the property to a new spouse if he or she remarries. The use of both a marital and a bypass trust will also minimize the federal estate taxes that will be due at the death of each spouse because it increases the likelihood that each spouse's applicable exclusion amount will be fully used.

May solve problem of overloading surviving spouse's estate

The use of a marital trust and a bypass trust can solve the problem of overloading the surviving spouse's estate. For couples with assets in excess of their combined applicable exclusion amounts, a concern is that if one spouse simply leaves all of his or her assets to the other spouse, then the deceased spouse's applicable exclusion amount will be wasted and the surviving spouse's estate may be overloaded (i.e., will have more assets than can be covered by his or her applicable exclusion amount). The first spouse to die has not used his or her applicable exclusion amount because all of his or her assets passed tax

free to the survivor through application of the unlimited marital deduction, leaving no assets to which the exclusion can be applied. However, with the use of both a marital and a bypass trust, both spouses may be able to fully use the applicable exclusion amounts available to them at the time of their respective deaths.

May be a good estate planning strategy if first spouse to die wants his or her assets to go to children or other beneficiaries

The use of a QTIP marital trust allows the first spouse to die to designate in the trust instrument that the assets in the QTIP marital trust will eventually go to his or her children or other beneficiaries. If the first spouse to die simply leaves his or her assets to the other spouse, the surviving spouse may leave those assets to a new spouse or to new children or may waste or spend down the assets, leaving nothing for the intended remainderpersons. Setting up a QTIP trust allows the surviving spouse to receive all income for life from the trust while allowing the first spouse to die to specify in the trust instrument to whom the assets will go when the surviving spouse dies.

Provides professional management of assets to surviving spouse and beneficiaries

Another advantage to the use of a marital and a bypass trust is that you can name a professional trustee to manage both trusts. If you are concerned that your spouse may lack the sophistication and experience to wisely manage the assets, you can appoint a bank trust department or a professional fiduciary to be the trustee of the trusts. You may also feel more comfortable having a professional trustee manage the assets in the trust if your children are young or irresponsible with money or would be able to influence an individual trustee to make distributions of principal for frivolous reasons.

Allows assets to avoid probate process

If assets are irrevocably transferred into the trusts during the lifetime of the grantor, those assets will avoid probate when the grantor dies. There are several disadvantages of going through probate. The first disadvantage is that there is a cost to having an estate probated. An attorney will have to be hired, and a formal process (dictated by state law) will have to be followed. Advertisements will have to be placed in newspapers, and other expenses will be incurred. The costs of probating an estate can be quite substantial. With a trust, there is no cost associated with distribution of the assets upon the death of the grantor. Of course, there is an initial cost to setting up the trust and transferring assets into the trust. An annual trustee's fee may also have to be paid.

A second disadvantage to probate is that there will be a time delay between the death of the decedent and the eventual distribution of the assets. In almost all states, the heirs may have to wait six months to two years or more before they receive their share of the assets. With a trust, some portion of the assets can be distributed immediately upon the death of the grantor.

A third disadvantage to probate is that the probate process is public. Anyone can go down to probate court and obtain a copy of your will and an inventory of your probate assets. They can see what assets you owned and how those assets will be distributed. A trust, conversely, is a private instrument that allows your assets and the distribution of those assets to remain private.

May allow favorable state death tax treatment

Certain states allow the holder of a general power of appointment over assets in a trust to exclude those assets from his or her estate for purposes of state death taxes. In most states (and for federal estate tax purposes), the holder of a general power of appointment is considered the owner of the assets, and those assets will be included in his or her taxable estate for state death tax purposes. However, in some states, assets subject to a general power of appointment held by a surviving spouse (i.e., the surviving spouse could appoint the assets for his or her own use) may be exempt from state inheritance taxes. Thus, in these particular states, you might be better off to leave the assets in a marital trust (with your spouse as the trustee) rather than leave them directly to your spouse. You should ask your attorney if you live in a state where the holder of a general power over trust assets can exclude the assets in the trust from state inheritance tax.

Allows executor to decide whether to pay estate taxes at the death of the first spouse

There are times when it makes sense to pay some estate taxes at the death of the first spouse. As noted, you may be better off to pay some estate tax at a lower marginal tax rate when the first spouse dies rather than overload the surviving spouse's estate and possibly pay estate tax at a higher marginal rate. However, the information needed to make this decision is often not available until the first spouse actually dies. By using both a marital trust and a bypass trust that will be funded at the death of the first spouse, the executor can be given the discretion to decide whether to include some assets in the taxable estate of the first spouse to die.

May be used to maximize use of the generation-skipping transfer tax (GSTT) exemption of both spouses

In recent years, many estate planning attorneys have designed bypass and QTIP marital trusts to maximize use of the generation-skipping transfer tax (GSTT) exemption of both spouses. The GSTT applies to a transfer from one individual to another person (known as a skip person) who is two generations or more below the transferor. The GSTT rate is 45 percent in 2008, and this tax is in addition to any gift or estate tax that may be due on such a transfer. Each individual has a lifetime exemption (\$2 million in 2008) from the tax. With the use of both a bypass trust and a QTIP trust, both spouses can maximize use of their individual GSTT exemptions and can leave up to \$4 million to a skip person(s) tax free. This area is extremely complicated and beyond the scope of this discussion. Please consult an estate planning attorney.

Example(s): You die in 2008 with a taxable estate of \$4 million. The executor of your estate allocates \$2 million of your assets to a bypass trust (to fully use your applicable exclusion amount) and then allocates the remaining \$2 million to a QTIP trust. All of the beneficiaries of the two trusts are skip persons to you and your spouse, so all distributions to the beneficiaries will be subject to the GSTT if the exemption does not apply.

The executor of your estate allocates your \$2 million GSTT exemption to the bypass trust. Thus, your entire GSTT exemption has been used. Your spouse can now use his or her GSTT exemption to shelter the remaining funds in the QTIP trust from the GSTT or may apply the balance of his or her GSTT exemption to his or her own assets.

What are the tradeoffs?

Attorney should be hired to draft and to transfer the assets into the trusts

Using both a bypass and a marital trust is a fairly complicated estate planning technique. You should hire a competent, experienced estate planning attorney to advise you and to draft the trusts. Furthermore, if you fund the trusts during your lifetime, you may need the assistance of your attorney to effectively retitle assets in the name of the trusts.

Trustee may have to be hired for the marital and bypass trusts

If the marital and bypass trusts are funded during the lifetime of the grantor, a trustee must be appointed to manage the trust assets. If you use a professional trustee (a bank trust department or a professional fiduciary), it will generally charge a fee. Typically, a professional trustee or fiduciary will receive a percentage of the assets under management as its fee, which may amount to 1 percent or more of the total assets in the trust.

Surviving spouse may not have full control over the assets transferred to the bypass trust

In order to not have the assets in the bypass trust included in the surviving spouse's taxable estate, the surviving spouse cannot be given full control over those assets. The surviving spouse, for example, cannot be given a general power of appointment over the assets in the trust. Many spouses may not like having limited control over assets that you have spent your lifetimes accumulating. Although the surviving spouse cannot be given complete control over the assets in the bypass trust, he or she can receive income for life from the trust. The trustee may also be given the discretion to distribute income to the surviving spouse (if needed) and may be authorized to distribute principal for the surviving spouse's health, maintenance, support, or education. The surviving spouse may also be given the power to annually demand up to 5 percent of the corpus or \$5,000, whichever is greater.

Surviving spouse may not have full control over the assets in the QTIP marital trust

Although the surviving spouse must have the right to receive all income for his or her lifetime from a QTIP trust, that spouse does not have to be given control over the assets in the trust. One of the main advantages of setting up a QTIP trust is that the spouses can be assured that their children or other intended beneficiaries will receive the assets remaining in the trust when the surviving spouse dies. Again, the surviving spouse may not relish having limited control over assets you have spent your lifetimes accumulating.

Grantor may not require the QTIP trust to hold non-income-producing assets

Another tradeoff to setting up a QTIP marital trust is that you, as the creator of the QTIP trust, cannot dictate that the trustee hold non-income-producing assets in the trust to preserve principal for the benefit of the remainder beneficiaries. The surviving spouse has to be given the right to require the trustee to invest the trust assets in income-producing property.

Example(s): For estate tax purposes, you want to set up a QTIP trust for your spouse. You would also like your children to inherit as much as possible from the trust. You would like to insert a provision into the trust agreement directing the trustee to invest in growth stocks that pay no dividends. Unfortunately, you are not allowed to dictate the type of investments that the trust holds. The surviving spouse must have the right to require the trustee to invest in income-producing assets.

Grantor loses power over disposition of the assets with a power of appointment trust

If you decide to set up the marital trust as a power of appointment trust, you lose the power to dictate where the assets will ultimately go when the surviving spouse dies. If you have children or other beneficiaries whom you would like to receive your assets upon the death of the surviving spouse, you should consider alternatives to the power of appointment trust. With a power of appointment trust, the surviving spouse must be given a general power of appointment over the trust assets. This means that he or she can use the assets for his or her own benefit (while alive) or transfer them to his or her estate, his or her creditors, the creditors of his or her estate, or any other person or entity upon his or her death.

Can a bypass and a marital trust be set up in your will?

Trusts set up in your will are known as testamentary trusts. The trust provisions are combined with and are part of the provisions of your will. At your death, the trust will be funded with the assets of your estate. One tradeoff to setting up testamentary trusts is that there may be a delay in probating your estate and funding the trusts. The probate of an estate can take from six months to two years (or longer). The trusts cannot be funded until the will has been probated. In contrast, an inter vivos or

lifetime trust may be funded during your lifetime. Your death does not affect the funding of inter vivos trusts.

What are the written provisions that should be put into a will to maximize the marital deduction?

Because you do not know for certain what the size of your estate and the amount of the applicable exclusion amount will be at your death, you cannot designate a specific amount in your will or trust to be transferred to the bypass trust in order to fully utilize the applicable exclusion amount then available to you. Most estate planning attorneys use one of two provisions in a will to guide the executor or trustee in deciding how the assets should be divided up into the bypass and marital trusts.

The first provision is known as the pecuniary formula bequest. With this method, a clause is inserted into your will or trust that instructs your executor or trustee to transfer into the marital trust the amount of assets sufficient to reduce the federal estate tax to the lowest amount possible (taking into consideration other credits available to you). In other words, the maximum amount of assets to completely exhaust the applicable exclusion amount will be placed in the bypass trust, and the remaining assets will be transferred into the marital trust thereby reducing your estate tax liability to zero (the lowest possible amount). The second provision that can be used is known as the fractional share bequest. Here, the surviving spouse receives a fractional share of the estate instead of a fixed amount. Language is inserted into the will or trust to the effect that the executor or trustee should transfer a fraction of the assets to the marital trust such that the federal estate taxes are reduced to the lowest amount possible (taking into consideration other credits available to you).

Which type of funding formula should you use in your will?

The type of funding formula that you should use depends largely on the type of assets that you own. If you think that the assets in your estate will increase in value during the period of the settlement of your estate (the time from when you die until the assets are distributed), you may want to use the pecuniary formula. This method applied to the marital share allows any increase in the value of the assets (i.e., appreciation) to be shifted to the bypass trust, thereby reducing the overall impact of the federal estate tax. With a pecuniary bequest, however, an income tax may be assessed against the estate on assets that have appreciated in value from the time of death until the time of the distribution to the bypass trust. This tax may be avoided with a fractional share bequest. There are no income tax consequences when the distribution is made pursuant to a fractional bequest. This area is extremely complicated. You should have an experienced, competent estate planning attorney review your estate plan with you and draft the appropriate provisions.

Can life insurance be used in conjunction with a marital and a bypass trust?

Many people use a revocable life insurance trust in conjunction with marital and bypass trusts. You create a revocable trust during your lifetime, take out a life insurance policy on your life, and name the trustee of the revocable trust as the beneficiary of the policy. When you die, the proceeds from the life insurance policy flow directly into the trust. The residue of your estate (what is left over after specific bequests, taxes, debts, and expenses) will also flow into this trust. The trust document will then authorize the trustee to divide the assets in this trust into both a bypass and a marital trust. The trustee can decide at the time of your death how best to divide the assets to minimize taxes and to provide for your family.

What are the tax considerations?

Income from assets transferred to a revocable living trust will be taxed to the grantor of the trust

If you transfer assets to a revocable living trust (set up while you are alive), any income generated from those assets during your lifetime will be taxed to you. Since the transfers to the trust are not irrevocable, you are still considered the owner of the assets for income tax purposes. When you die, the income from the trust will be taxed to either the trust or its beneficiaries, depending on whether the income is retained by the trust or paid out.

Example(s): You set up a revocable living trust and transfer \$1 million to the trust. The assets in the trust generate \$40,000 per year in income. You will be taxed each year on this income. When you die, the beneficiaries will be taxed on this income if it is distributed to them. If the trust retains the income, the trust itself will be taxed on the income.

No gift tax is due for transfers to a revocable living trust

Because you retain the right to terminate a revocable living trust, no gift tax is due at the time of the transfer into the trust because the gift is incomplete. Those assets, however, will be included in your federal taxable estate when you die.

Gift tax may be due on transfers into an irrevocable trust

A gift tax may be due if you make transfers into an irrevocable trust during your lifetime. However, gift tax due may be offset by your gift tax applicable exclusion amount of \$1 million, if it is available.

Caution: Keep in mind that applicable exclusion amount for gift tax purposes is fixed at \$1 million while the applicable exclusion amount for estate tax purposes increases through 2009. Any portion of your gift tax applicable exclusion amount you use during your lifetime

effectively reduces your estate tax applicable exclusion amount that will be available at your death.

After death, assets going into marital trusts will qualify for the unlimited marital deduction

After your death, any assets that are transferred by your executor into a marital trust (a power of appointment trust, an estate trust, or a QTIP trust) will qualify for the unlimited marital deduction. You can leave an unlimited amount of assets to your spouse in one of these marital trusts and not incur any estate taxes on those assets at your death. Your spouse will then be taxed at his or her death on those assets. Of course, your spouse can then use his or her applicable exclusion amount to shelter either a portion or all of the assets from the estate tax. You should also remember that you can simply leave the assets (that would otherwise go into the marital trust) outright to your surviving spouse. However, if you leave the assets to your spouse outright, you would not have control over the ultimate disposition of the assets when the surviving spouse dies as you would have if you left the assets to your spouse in a QTIP trust.

Assets transferred into a bypass trust are included in taxable estate of grantor

Any assets that you transfer into the bypass trust will be included in your taxable estate. However, you can use your applicable exclusion amount to shelter these assets from federal estate tax. Most people authorize their executor to transfer just enough assets into the bypass trust to fully use the applicable exclusion amount then available to them and to distribute the remainder of the assets to the surviving spouse or to a marital trust for his or her benefit. With this method, no estate taxes will be due upon the death of the first spouse to die. However, some people may want to transfer assets above the applicable exclusion amount into the bypass trust and pay federal estate tax upon the death of the first spouse to die. This may be preferable to overloading the surviving spouse's estate, where the marginal federal estate tax rate may be much higher.

GSTT will apply to transfers to beneficiaries two generations or more below grantor

The GSTT may apply to trusts where some or all of the beneficiaries (known as skip persons) are two or more generations below the grantor. The GSTT will apply if income or principal from the trust is paid to a skip person, if the trust terminates and assets are then distributed to a skip person, or if a beneficiary of the trust who is not a skip person dies leaving only skip persons as beneficiaries. GSTT will also apply to transfers to a trust that is itself a skip person.

Tip: The GSTT rate is the same as the maximum estate tax rate, and, in tax years after 2003, the GSTT exemption is the same amount as the estate tax applicable exclusion amount.

What if you live in a community property state?

Each spouse in community property state is considered to own one-half of community property

Estate planning in community property states using bypass and marital trusts can be complicated by the fact that one-half of the community property automatically belongs to the surviving spouse. This property will not be subject to any pourover provisions of the will of the first spouse to die (i.e., the first spouse to die cannot indicate in his or her will that this property should pass to a trust). However, this problem can be avoided if the surviving spouse freely agrees that the first spouse to die can distribute all of the community property to the marital and bypass trusts.

Marital deduction rules apply to community property states

The marital deduction rules also apply to community property states. Therefore, a spouse can leave an unlimited amount of assets to his or her spouse without incurring any estate taxes upon the death of the first spouse. One spouse can also transfer an unlimited amount of assets during his or her lifetime (through gifts) to his or her spouse. A married couple in a community property state can thus defer the imposition of federal estate taxes until the death of the second spouse.

Holding property in joint tenancy in community property states can result in overloading surviving spouse's estate

In both common law and community property states, if a married couple holds property in joint tenancy with rights of survivorship, that property will automatically go to the surviving spouse upon the death of the first spouse. The will of the first spouse to die does not control the disposition of this jointly owned property. Thus, there is a danger that the surviving spouse's estate will be overloaded unless the marital deduction provisions of the trust are drafted to reduce the amount of assets transferred into the marital trust by the amount passing directly to the surviving spouse. Therefore, holding a large percentage of potential trust assets in joint tenancy can defeat the purpose of marital and bypass trust planning.

Does it ever make sense for a married couple to pay estate taxes at the death of the first spouse?

There may be situations where a couple will actually be better off to pay some estate taxes at the death of the first spouse. If the marginal rate applicable to the estate of the first spouse to die is relatively low, it may make sense to include enough assets in the taxable estate of the first spouse to die to pay some federal estate taxes at the lower rate. These assets will not be included in the surviving spouse's taxable estate. If the surviving spouse is likely to have substantial assets of his or her own, the couple may be better off to pay the lower tax rates at the death of the first spouse rather than overload the surviving spouse's estate, where the marginal tax rates may be much higher.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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