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ESTATE PLANNING CONCEPTS SUMMER 2010

Should You Convert to a Roth IRA?

Effective in 2010, all taxpayers, regardless of the amount of their adjusted gross income (AGI), can convert a traditional individual retirement account (IRA) to a Roth IRA. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but they are exempt from the 10% early

withdrawal penalty.

If you make a conversion in 2010, the tax can be paid in two installments in 2011 and 2012, with no tax due in 2010. However, if you prefer, you can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010 or you expect much higher income in 2011 or 2012. Taxes on conversions made after 2010 must

be paid in the year of conversion.

The question is whether it makes financial sense to pay what could be a large income tax bill now to avoid any future income taxes on your IRA. Several factors need to be considered before answering that question:

What is your income tax bracket now, and what will it be when the funds are distributed? If your tax bracket will be the same at both times, the financial results will be similar. Increasing income tax brackets generally make it advantageous to convert to a Roth IRA, since you are paying the tax bill while income tax rates are lower. Decreasing tax brackets generally favor leaving the balance in the traditional IRA.

How will you pay the income taxes due from the conversion? If you can pay the tax bill from sources outside your IRA, that is a strong factor in favor of conversion. By doing so, you are in essence making an additional contribution to the IRA in the amount of the tax paid. Conversely, paying the tax bill from your IRA account can be a strong factor against converting, since you are withdrawing funds from your IRA and may also have to pay a 10% penalty on that withdrawal.

When will you make withdrawals from your IRA? If you'll make withdrawals within five or 10 years of converting, that may not be

Encourage Estate Planning

Parenting is a never-ending job. Even when your children are grown, there will probably be lessons you'll want to teach them, such as the need for estate planning. Some items to include in that lesson are:

- **Explain why estate planning is important.** Your role is not to dictate what they should do with their estate, just to emphasize the need for estate planning. When your children encounter major life events, such as marriage, divorce, or a child's birth, remind them to review their estate plans.
- **Make sure all important estate-planning documents are in place.** At a minimum, every adult should have a will, a durable power of attorney, and a health care proxy. A durable power of attorney designates an individual to control their financial affairs if they become incapacitated, while a health care proxy delegates health care decisions to a third person when they are unable to make those decisions.
- **Coordinate estate planning across generations.** If you have a substantial estate, you may want to coordinate your estate planning efforts with those of your children. A coordinated effort can help minimize estate taxes. ○○○

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Should You Convert?

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enough time for the benefits of tax-free compounding to compensate for the current payment of income taxes. But if you don't need to make withdrawals, your balance in a Roth IRA can grow tax free for a longer time, since you don't have to make required minimum distributions after age 70½.

How will the income from the conversion affect your overall tax situation? That additional income could raise your overall income to a point where you lose some tax credits, deductions, or exemptions in the year of conversion.

Will your Social Security benefits be subject to taxes? In the year of conversion, the income from the conversion may affect your Social Security benefits. However, going forward, distributions from Roth IRAs are excluded from taxable income, while distributions from traditional IRAs may affect your benefits.

Are you interested in other estate planning considerations? Paying income taxes currently means that you remove those assets from your taxable estate, thus reducing estate taxes owed at your death. If you plan to leave the IRA balance to your heirs, your heirs receive the Roth IRA proceeds free of income taxes, while income taxes would be due on the traditional IRA. Also, if you don't take withdrawals from the Roth IRA after age 70½, you may end up leaving your heirs with a much larger balance.

After considering all of these factors, you can decide whether converting makes sense for your situation. Keep in mind that you do not have to convert your entire IRA balance at one time. You can convert over a number of years or only convert a portion of your IRA balance. However, be aware that if you have both deductible and nondeductible IRA balances, you cannot just convert the nondeductible balances to reduce your tax liability. You have to

assume a pro-rated portion of both the deductible and nondeductible IRA funds are being converted.

Know When to Recharacterize

If you convert and your investments then decline, you end up paying taxes on more than the current market value. However, you can then recharacterize your conversion. For conversions made in 2010, you can recharacterize until October 15, 2011, meaning you can convert back to your original IRA. After the recharacterization, it is as if you did not convert, so you owe no taxes. You can then reconvert at the later of 30 days after the recharacterization or the beginning of the tax year following the first conversion.

You can recharacterize just a portion of the conversion. However, if you have several investments in the IRA, you can't simply choose the ones with the largest losses. In that situation, a pro-rated portion of all the investments in the account will be considered in the recharacterization. You can bypass this rule by setting up separate Roth IRA accounts for each investment. Then, if one

declines substantially, you can recharacterize that one Roth IRA.

Roth IRA Contributions

This new conversion provision effectively removes the income limitations for contributions to a Roth IRA. In 2010, Roth IRA contributions can be made by single taxpayers with AGI less than \$105,000 (contributions are phased out with AGI between \$105,000 and \$120,000) and by married couples filing jointly with AGI less than \$167,000 (contributions are phased out with AGI between \$167,000 and \$177,000). It doesn't matter whether you participate in a company-sponsored pension plan. Individuals with incomes over the limits can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA. However, keep in mind that if you have other deductible IRA balances, you will have to assume a pro-rated portion of both the deductible and nondeductible IRA funds are converted.

Please call if you'd like help deciding whether you should convert to a Roth IRA. ○○○

Estate Planning Benefits of Roth IRAs

A Roth IRA offers estate-planning advantages not available with a traditional IRA. Those advantages relate primarily to the following features:

- **The account owner is not required to take withdrawals after age 70½.** With a traditional IRA, minimum required distributions must be made after the latter of age 70½ or retirement, based on the account owner's life expectancy. With a Roth IRA, you can leave the funds in the Roth IRA to continue accumulating on a tax-free basis.
- **Withdrawals made by beneficiaries are received income-tax free.** With both Roth and traditional IRAs, the IRA's value at the date of your death is included in your taxable estate and may be subject to estate taxes. However,

the income tax treatment is substantially different. Withdrawals from traditional IRAs are subject to ordinary income taxes, while qualified withdrawals from Roth IRAs can be taken income-tax free. If beneficiaries elect to take withdrawals over their life expectancy, the funds in the Roth IRA will continue to grow on a tax-free basis and withdrawals will be free of federal income taxes. Beneficiaries must start taking withdrawals by December 31 of the year following your death to be able to withdraw funds over their life expectancy. If they wait, the entire balance must be cashed out by the end of the fifth year following your death. Be aware that different rules apply to beneficiaries who are spouses. ○○○

Estate Planning for Blended Families

While estate planning can be complex for all families, it can be especially complex for those in other than a first marriage. In addition to considering your spouse and children from your current marriage, both you and your spouse may have children from prior marriages. Ensuring that everyone is treated fairly can be a challenge, but these tips can help:

- **Sit down with your spouse and discuss both of your desires.** Make a list of assets you each brought into the marriage as well as assets acquired after your marriage. Discuss how you want these assets distributed after your death. Your estate planning documents should support these decisions. Keep in mind that even if you have a will, your spouse can often override the terms and elect to receive a statutory percentage of your estate. To prevent this, you typically need a prenuptial or nuptial agreement.
- **Determine whether trusts are necessary to protect your children's inheritance.** When assets are left outright to your spouse, he/she controls the ultimate distribution of those assets. You may want to use a qualified terminable interest property trust (commonly referred to as a QTIP trust) to protect your children's interests. Assets you designate are placed in this trust with income distributed to your spouse during his/her lifetime. After your spouse's death, the principal is distributed to your heirs.
- **Review beneficiary designations and life insurance amounts.** It's not unusual to forget to update beneficiary designations for retirement accounts, individual retirement accounts, and life insurance policies. These assets will be distributed to your named

beneficiaries, regardless of your estate planning documents. Thus, take a look at those designations to ensure they are coordinated with your estate plans. While you're at it, review how much life insurance you have. You may find that you need more life insurance.

- **Check how your property is titled.** Jointly owned property automatically passes to the co-owner. You cannot change this distribution through a will.
- **Discuss your plans with your family.** Especially in situations involving stepparents and stepchildren, you should communicate your plans for your estate.

You don't want your children to believe that your spouse has unduly influenced you or that you don't care about them. Being open and upfront about your estate plan will hopefully prevent misunderstandings after your death. ○○○



Pay Yourself First

The advice sounds simple enough — to force yourself to save regularly, treat those savings as a bill to yourself and pay that bill first every month. If you're looking for ways to start paying yourself first, consider the following:

- **Reduce spending, diverting those reductions to savings.** One way to accomplish this is to cut back on your spending, perhaps reducing your expenditures for eating out, traveling, clothing, or entertainment. But for many people, this feels too much like sacrifice, making it difficult to stick with this strategy. Another alternative is to find ways to spend less for the same items. For instance, get quotes for your car and home insurance from several companies, placing any premium reductions in savings. Or find ways to reduce your borrowing costs.
- **Save all unexpected income.** Immediately save any money from tax refunds, bonuses, cash

gifts, and inheritances. Before you get used to any salary increases, put that raise into savings.

- **Make saving automatic.** Resolve to immediately set up an investment account that automatically deducts money from your bank account every month. Start out with small amounts that aren't even noticeable. As you get used to saving on a regular basis, increase the amount periodically. Another good alternative is to sign up for your company's 401(k) plan. Not only will the amount be automatically withdrawn from your paycheck, but you won't pay current income taxes on those contributions. *(Keep in mind that any automatic investing plan, such as dollar cost averaging, does not assure a profit or protect against loss in declining markets. Because such a strategy involves periodic investment, consider your financial ability and willingness to continue purchases through periods of low price levels.)* ○○○

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Distributing Your Estate to Grown Children

When your children were young, your primary concern was probably how to provide for them in the event you and your spouse died. Even though they may now be grown, your children are probably still the center of your estate plan. Just because they are adults doesn't mean that you have to leave their entire inheritance to them outright. Consider these factors first:

- **Do you want to distribute your estate gradually?** If substantial assets are involved, you may want to set up trusts to distribute your assets gradually, such as in thirds when each child reaches ages 25, 30, and 35. You can always give the trustee power to make early distributions for items like paying for college, starting a business, or purchasing a home.
- **Have you selected a trustee carefully?** If trusts are involved,



you want a trustee who is impartial and will deal fairly with all your children. Think twice before naming one of your children as trustee. One sibling in a position to decide what happens to another sibling's inheritance can cause disagreements between siblings.

- **Have you thought about the consequences of a child divorcing?** You probably don't want a portion of your assets distributed to an ex-daughter-in-law or ex-son-in-law, so special provisions may need to be added to trusts.
- **Have you considered how assets will be distributed among children?** Perhaps one child is better off financially than your other children. Do you divide your estate equally or give less to the financially well-off child? Children often feel a right to an equal share of their parents' estate, even if they have a substantial estate of their own. If you decide to make unequal distributions, be sure to explain why personally or in a letter left with your estate planning documents. Hopefully, this will prevent hurt feelings or disagreements among siblings.
- **Do you need to make special distributions to even out inheritances?** Perhaps you have paid all college costs for some chil-

dren, while other children have not attended college yet. You may want to ensure that all children receive a college education, and then distribute the rest of your estate equally among your children.

- **Should you coordinate your estate plan with your children's estate plans?** If your children have substantial estates of their own, it may not make sense to leave additional assets to them. They may prefer those assets go directly to their children, helping to minimize family estate taxes.
- **Have you explained the need for estate planning to your children?** Especially if you are leaving a substantial estate to your children, they may need to plan their own estates. You don't need to dictate what they should do with their estates, but gently remind them why they need an estate plan. After major life events, such as marriage, divorce, or a child's birth, remind your children to revise their estate plans.

Please call if you'd like to discuss distributing your estate in more detail. ○○○

FR2010-0222-0484

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