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PERKINS & ZAYED, P.C.
THE ESTATE AND TRUST LAW GROUP

ATTORNEYS AND COUNSELORS AT LAW
Mark Perkins, Esq.
Principal

1751 S. Naperville Rd., Suite 203
Wheaton, IL 60189
630-665-2300
630-665-4343 Fax
mperkins@att.net

ESTATE PLANNING CONCEPTS

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What Happens If You Become Disabled?

For many people, a long-term disability would be financially devastating. Although no one likes to think about this possibility, you should consider your options now so you can obtain disability income insurance if needed.

When considering a long-term disability, assess your income needs until age 65, when presumably retirement benefits would begin. During this analysis, consider the following items:

- **Estimate your monthly expenses following a disability.** Typically, some of your disability benefits would be free of income taxes (if you paid the premiums) and you won't incur work-related expenses. However, don't underestimate your expenses, since your medical and rehabilitation expenses might be much higher after a disability. Find out if you would continue to be covered under your employer's health insurance plan. If not, you'll need to make provisions for that expense.
- **Review your annual Social Security statement for an estimate of disability benefits.** However, keep in mind that the eligibility requirements are quite stringent — you must be totally disabled, have little or no chance of recovery, and wait six months or longer for your first check. Even if you do qualify, benefits tend to be modest.
- **Decide what personal resources you would want to use.** You can access funds from individual retirement accounts, annuities, or 401(k) plans without penalty if you are disabled. But first consider whether you want to risk depleting your retirement fund or children's college funds due to a long-term disability.
- **Investigate any long-term disability benefits provided by your employer.** Long-term group disability plans are less common and typically less common than short-term plans. The policies frequently have strict definitions of disability, pay up to 60% of your base salary (bonuses and commissions generally aren't included), pay two to five years of benefits, and don't provide cost-of-living increases. Also factor in income taxes that must be paid on any benefits your employer paid for. Check to see if your employer-sponsored retirement plan offers an option for early retirement in case of disability.
- **Consider purchasing disability**

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New and Announcements

It's That Time Again

If we haven't met within the last few years, we should get together now to review your estate plan. Laws are constantly changing. Therefore, it is important to monitor your progress at least every few years to ensure that you continue to be on the right path for your estate plan. Especially with all of the market turmoil over the past year, we should take the time to go over your entire plan.

Please don't procrastinate. Call our office today, and we will be happy to schedule an appointment as quickly as possible.

Do I Have Your E-mail Address?

While there have been a number of technological advancements over the past several years, for many, the use of e-mail has had a greater effect on a daily basis than any other single development.

E-mail provides the ability to instantly communicate with other individuals, regardless of where they are in the world. The old-fashioned postal service is quickly being replaced by the electronic transmission of messages.

When it comes to estate planning services, e-mail has been a highly effective way to exchange information. Sending and receiving e-mails on a regular basis is a great way to stay in contact. If I sent you an e-mail in the past, then you are already aware of e-mail's convenience.

If you have e-mail and don't recall receiving a message from me, it's because I don't have your e-mail address. If that is the case, I would appreciate it if you could give me a call or send an e-mail to provide me with your current e-mail address. I will be sure to add you to my e-mail address book.

What Happens?

Continued from page 1

income insurance to fill any gaps. However, you might not be able to replace more than 60% to 80% of your income through insurance, since insurers want you to have an incentive to return to work. Any benefits from policies you paid the premiums for are received income tax free. Coordinate your employer-provided insurance and your own policy so that the maximum benefits do not exceed the amount the insurance companies will pay. Otherwise, you may pay for coverage you won't receive.

If you decide to purchase disability income insurance, make sure to consider these things:

❍ **Pay special attention to the definition of disability.** There are three basic types of coverage: own occupation, any occupation, and income replacement. Own occupation pays benefits when you can't work at your specific occupation. Many professionals, such as doctors and lawyers, opt for this coverage. However, due to substantial claims, this coverage is now more difficult to obtain. You may be able to find own occupation coverage for a specified period, with the policy then converting to any occupation coverage. Any occupation means you must be unable to work at any occupation that your training and education would be suited for. Income replacement policies pay the difference between what you were earning before the disability and what you are earning now. For most individuals, income replacement policies will provide the best balance between cost and benefits.

❍ **Opt for a long waiting period before benefits start.** This is a good way to reduce premiums, provided you have other resources to rely on for the short term, such as sick leave, personal savings and investments, and short-term disability coverage. Waiting periods can range from one week to two years, but the most common option is a 90-day delay in benefits.

❍ **Consider coverage that pays benefits until age 65.** Disability insurance is designed to protect your financial situation from a serious disability, so you should obtain coverage for the long term. Policies for lifetime benefits are rare and expensive. It's probably not needed, however, since you will probably be eligible for Social Security and other retirement benefits once you turn 65.

❍ **Look for a policy that provides residual benefits.** This allows you to return to work on a part-time basis and still receive partial benefits.

❍ **Make sure the policy is either noncancelable or guaranteed renewable.** Noncancelable means you can renew the policy every year at the same premium. Guaranteed renewable means you can renew the policy every year, but the premium can increase as long as it is not done so in a discriminatory manner. Either provision will ensure that the policy can't be canceled due to medical problems.

Please call if you'd like to discuss your need for disability income insurance in more detail. ❍❍❍

New Tax Rules for Vacation Homes

In the past, it was possible to turn a vacation home or rental home into your principal residence so that you could later sell it and exclude gains on the sale from income. If you were planning on such a strategy, be aware that the tax rules recently changed.

Prior to the tax law change, you could purchase a vacation home or rental property years before you retired. Once you retired, you could sell your principal residence. As long as you lived in that home for two of the last five years before selling, you could then sell the home and exclude up to $250,000 of gain if you are single and up to $500,000 of gain if you are married filing jointly. After that, you could move into your vacation home and use it as your principal residence. Then, as long as you had lived in the vacation home at least two of the last five years before selling, you could sell that home and exclude the gain up to the limits noted above.

The new law now separates holding periods into qualified and nonqualified use. When a home is sold, the gain must be allocated between qualified and nonqualified use, with the portion of the gain related to nonqualified use included in taxable income.

The law is effective after December 31, 2008. Qualified holding periods include:

❍ Holding periods prior to January 1, 2009;

❍ Holding periods after January 1, 2009, where the taxpayer uses the residence as his/her principal residence; and

❍ Any portion of the five-year period after the taxpayer's use of the property as a principal residence, provided the home is sold within that five-year period.

To count as qualified use, the home must be used as the principal residence by the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse. A temporary absence from the home for reasons of employment, health, or unforeseen circumstances not exceeding two years does not count as nonqualified use. Any period up to 10 years that the taxpayer or the taxpayer's spouse is serving on extended military duty also does not count as nonqualified use.

When a principal residence with nonqualified use is sold, even if the home has served as the principal residence for two of the last five years preceding the sale, any gain must be allocated between qualified and nonqualified use. Gains related to nonqualified use must be included in income, taxable at capital gains rates as long as the home was held over one year.

Thus, starting in 2009, there is no tax benefit to taxpayers to purchase a vacation home that will later be converted to a principal residence. For those who already own vacation homes, the longer the pre-2009 holding period and the sooner the vacation home is converted to a principal residence, the better for the taxpayer. ❍❍❍

Passing on Valuable Life Lessons

You're looking for an effective way to get your heirs to do what you think is best for them, for the family, and for the world. Is an incentive trust the right vehicle to accomplish that?

An incentive trust is much like a traditional irrevocable trust, except that it sets specific conditions on trust distributions. Some people establish incentive trusts to make sure beneficiaries stay in the family business. Others want to encourage higher education or public service. Some want to discourage behavior — laziness, reckless spending, or drug use. Still others want to encourage beneficiaries to get married and raise a family.

If you think an incentive trust may be a useful part of your estate plan, consider the advantages and disadvantages. The advantages of incentive trusts include:

- If you write the conditions for disbursement properly, they provide objective criteria for when and how to make these disbursements.
- They encourage beneficiaries to behave in ways that are important to you.
- They allow you to condition disbursement on your beneficiary's age, so you can decide when he/she is old enough to responsibly manage the inheritance.
- They can help you accomplish goals through your beneficiaries, such as continuing the family business or pursuing philanthropic interests.

But there are also disadvantages:

- While incentive trusts allow you to specify conditions for distributions, they restrict the ability of trustees to make different decisions if new circumstances arise.
- Incentive trusts can cause resentment among beneficiaries, who may feel it is not your place to tell them how to live their lives.
- Encouraging goals you think are important may cause beneficiaries to neglect other good opportunities. For example, you may want a beneficiary to start a business, but she may be better suited to another career choice.
- Incentive trusts may be plagued by the law of unintended consequences. How can you foresee the future long after you've died? You may instruct the trust to pay out a stipend for your beneficiaries to go to school, but that can encourage them to become "professional" students.
- Because incentive trusts are often more complicated than traditional irrevocable trusts, they may be more expensive to establish and maintain.

There are a number of issues that could affect the design and implementation of an incentive trust. Consider these points carefully:

- **Goals** — What behaviors do you want to promote? Incentive trusts are often created to encourage beneficiaries to pursue higher education degrees. Discouraging reckless consumption and unproductive behavior are other common reasons behind incentive trusts. Think about what matters to you and your beneficiaries.
- **Coordination with your estate plan** — Incentive trusts are just one component of an estate plan. Decide whether you want to create a separate incentive trust or build incentive clauses into a trust designed for another purpose. Make sure the incentive trust doesn't conflict with or detract from other components.
- **Duration** — How long do you want the incentive trust to last? For grantors with substantial wealth, a trust may span many generations.
- **Beneficiaries** — Who will benefit from the monies disbursed from the incentive trust?
- **Trustee designation** — The trustee of an incentive trust typically has a more difficult job than the trustee of a simple traditional trust, since he/she must decide when beneficiaries have met the conditions you specified. Make that job easier by writing conditions that are objective.

If you decide an incentive trust may be right for you, you should:

- Sit down with your beneficiaries and trustee to discuss your goals for the incentive trust.
- Build flexibility into the trust to accommodate changes in circumstances.
- Ensure that the conditions you want to include comply with state and federal laws.

If you don't want to establish an incentive trust, you can limit each beneficiary's inheritance to an amount that isn't likely to encourage reckless consumption and unproductive behavior. Another alternative, if your interest lies in philanthropy, is to establish a private foundation and name your beneficiaries as board members. That way, your money is still controlled by your beneficiaries, but it is put to charitable use.

Please call if you'd like to discuss incentive trusts in more detail. ❍❍❍

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Encourage Your Child to Fund an IRA

Once your child starts working, help him/her develop good savings habits by encouraging him/her to fund an individual retirement account (IRA). Even if your child only contributes for a few years, an IRA can provide significant funds for retirement.

Your child must have earned income to contribute to an IRA and may only contribute the lesser of earned income or the maximum IRA contribution. The maximum limit is $5,000 in 2009 and 2010.

Assume your 16-year-old daughter starts working part-time. If she contributes $2,000 to an IRA from the ages of 16 to 22, she will contribute $14,000 over seven years. With no further contributions, the IRA could potentially grow to $527,437 on a tax-deferred or tax-free basis by age 65. That assumes earnings of 8% compounded annually but does not include any income taxes that might be due.

If your child continues $2,000 IRA contributions until age 65, she would make total contributions of $98,000 and could accumulate investments of $1,145,540. (These examples are provided for illustrative purposes only and are not intended to project the performance of a specific investment vehicle.)

Although most children will be eligible to contribute to both a traditional deductible IRA and a Roth IRA, you should probably encourage your child to fund a Roth IRA, which has several advantages:

- **Roth IRAs are more flexible.** Your child can withdraw all or part of his/her contributions at any time, without paying federal income taxes or penalties. Thus, if your child later decides to use contributions for college, a car, a down payment on a home, or for some other purpose, contributions can be withdrawn with no tax consequences.
- **Earnings accumulate tax free, plus qualified distributions can be withdrawn tax free.** A qualified distribution is one made at least five years after the first contribution and after age 59 1/2. There are also certain circumstances where earnings can be withdrawn without paying income taxes and/or the 10% federal income tax penalty. If your child allows the funds to grow until at least age 59 1/2, all contributions and earnings can be withdrawn without paying any federal income taxes.
- **A traditional deductible IRA offers little tax benefit to a child.** When your child first starts working, he/she will typically pay a low marginal tax rate on his/her income. So even though the Roth IRA contribution is not tax deductible, your child typically receives little or no tax benefit from deducting the traditional IRA contribution anyway.

If you can't convince your child to use his/her own money to fund the IRA, consider reimbursing him/her, as part of your annual gift tax exclusion, for any IRA contributions. Hopefully, you will also teach your child some important lessons about saving at an early age. Please call if you'd like to discuss how to implement this strategy for your child or grandchild. ❍❍❍

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