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ESTATE PLANNING CONCEPTS

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Focus on the Fundamentals

When faced with all the decisions that need to be made to ensure you select appropriate investments to help pursue your long-term investment goals, it's easy to become overwhelmed. How do you choose the right combination of investments to help you work toward a goal that may be decades away? The answer is to focus on the

basics. Make sure you are getting these fundamentals right:

- **Don't wait — invest now.** To put the power of compounding to work for you, start investing now. It's easy to put off investing, thinking you'll have more money or more time at some point in the future. Typically, however, you'll be better off saving less now than waiting and saving more later.
- **Live below your means, so you can invest more.** The amount of money you have left over for investing is a direct result of your lifestyle. Don't have any money left over for investing? Ruthlessly cut your living expenses and redirect all those reductions to investments. This should significantly help with your retirement. First, you'll be saving significant sums for that goal. Second, you'll be living on significantly less than you're earning, so you'll need less for retirement.
- **Maintain reasonable return expectations.** When developing your financial goals, you'll typically decide how much you need, when you'll need the money, and how much you'll earn on those savings. Those factors will determine how much you need to save on an annual basis to reach your goals. The higher your expected

Spousal IRAs

Perhaps you are a stay-at-home parent, or your spouse is a professor on an unpaid sabbatical. Even though you are not working, you still need to consider retirement plans. A spousal individual retirement account (IRA) allows a nonworking spouse to contribute to an IRA, even though the spouse has little or no earned income. Here are the basics:

- To be eligible to contribute, the couple must be legally married at tax year-end and file taxes jointly. The couple's combined earned income must equal or exceed the combined IRA contribution.
- Contributions can be made to traditional IRAs as long as the owner is under age 70 1/2, while there is no age limit for Roth IRAs.
- In 2008, the maximum contribution to an IRA is \$5,000 with an additional \$1,000 catch-up contribution for individuals age 50 and over.
- For traditional IRAs, if the working spouse is covered by a qualified retirement plan but the nonworking spouse is not, the contribution for the nonworking spouse is phased out once adjusted gross income (AGI) is between \$159,000 and \$169,000 in 2008 and totally phased out once income exceeds \$169,000. If you both have earned income equal to at least the maximum IRA contribution amount and are both covered by a qualified retirement plan, your contribution is phased out at joint AGI between \$85,000 and \$105,000 in 2008. If neither of you is covered by a qualified plan, both of you can make a deductible contribution regardless of your AGI.
- For Roth IRAs, eligibility is phased out for AGI levels between \$159,000 and \$169,000 in 2008. It doesn't matter whether your spouse is covered by a qualified retirement plan at work.

Contributing to a spouse's IRA may be as beneficial to the working spouse as to the nonworking spouse, since the assets are likely to be shared during retirement. Please call if you'd like to review whether you or your spouse are eligible to contribute to a spousal IRA. ○○○

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the Fundamentals

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return on your investments, the less you need to save every year. However, if your assumed rate of return is significantly higher than your actual rate of return, you won't reach your goals. Thus, it's important to come up with reasonable return expectations. While past returns aren't a guarantee of future returns, you'll want to start by reviewing historical rates of return. You can then adjust those returns based on your expectations for the future.

- **Understand that risk can't be totally avoided.** All investments are subject to different types of risk, which can affect the investment's return. Cash is primarily affected by purchasing-power risk, or the risk that its purchasing power will decrease due to inflation. Bonds are subject to interest-rate risk, or the risk that interest rates will rise and cause the bond's value to decrease, and default risk, or the risk that the issuer will not repay the bond. Stocks are primarily subject to nonmarket risk, or the risk that events specific to a company or its industry will adversely affect a stock's price, and market risk, or the risk that a stock will be affected by overall stock market movements. These risks make some investments more suitable for longer investment periods and others more suitable for shorter investment periods.
- **Diversify your portfolio.** Typically, you do not know which asset class will perform best on a year-to-year basis. Diversification is a defensive strategy — it helps protect your portfolio during market downturns and helps reduce its volatility. Diversify your investment portfolio among a variety of investment categories, such as stocks, bonds, cash, real estate, and other alternatives. Also diversify within investment categories.

Your Estate Plan

Usually, a great deal of thought and effort goes into estate planning documents. However, your work isn't over once you've signed those documents. Some problems to look out for include:

- **Your assets aren't titled properly to fund trusts.** A common estate planning strategy used to preserve your estate tax exclusion is to set up a credit shelter or bypass trust. Assets up to the estate tax exclusion amount (\$2,000,000 in 2008, scheduled to increase to \$3,500,000 in 2009) are placed in a trust. Your spouse can then use the income and even some of the principal, with the remaining assets distributed to your beneficiaries after your spouse's death. To fund the trust, however, you need sufficient assets titled only in your name. Assets jointly owned with your spouse will typically pass directly to your spouse and cannot be placed in the trust. However, you may want to split assets so each of you individually owns assets designated to go into the trust. Residents of community-property states should review their state laws carefully, since they typically have more flexibility when using assets to fund trusts.
- **Beneficiary designations contradict your estate planning documents.** Assets like life insurance, annuities, 401(k) plans, and individual retirement accounts pass directly to named beneficiaries. Provisions in your will and other estate planning documents cannot change those designations. Thus, review all your beneficiary designations to ensure those designations are compatible with your estate plan. Also review contingent beneficiaries, in case a beneficiary dies before you.
- **Owning assets jointly with just one child.** Often, a widow or widower will add one child to bank accounts, brokerage accounts, deeds, and titles so that child can help manage the assets if he/she becomes incapacitated. The widow or widower expects the child to share the assets with his/her siblings. However, the asset is considered a gift to the one child. For that child to split the asset with his/her siblings, he/she will have to make gifts to those siblings, possibly raising gift tax implications. Instead, consider using a power of attorney, so the one child can help with your financial affairs. Or, make a provision in your estate planning documents that adjusts distributions for any assets that pass to one heir through joint ownership. ○○○
- **Only invest in the stock market for the long term.** Stocks should only be considered by investors with an investment time frame of at least five years. Remaining in the market over the long term reduces the risk of receiving a lower return than you expected.
- **Don't try to time the market.** Timing the market is a difficult strategy to successfully accomplish, since so many factors affect the market. Remember that most people, including professionals, have difficulty timing the market with any degree of accuracy. Instead, concentrate on setting an investment program that works in all market environments and that you can stick with in good and bad times.
- **Pay attention to taxes.** Taxes are probably your portfolio's largest expense. Ordinary income taxes on short-term capital gains and losses can go as high as 35%, while long-term capital gains and dividend income are taxed at rates not exceeding 15% (0% if you are in the 10% or 15% tax bracket). Using strategies that defer income for as long as possible can make a substantial difference in the ultimate size of your portfolio. ○○○

Stretching Your IRA

Individual retirement accounts (IRAs) are usually viewed as retirement planning vehicles. But with increased contribution amounts and the ability to roll over 401(k) balances to an IRA, many IRA owners are finding they won't use the entire IRA balance for retirement. Thus, IRAs are increasingly becoming major estate planning tools. When used for estate planning, the goal is to extend the IRA's life as long as possible so that beneficiaries can benefit from the tax-deferred (for traditional IRAs) or tax-free (for Roth IRAs) growth. How can you accomplish that?

Assume you have a large traditional IRA balance, which includes a rollover from your 401(k) plan. You don't have to start taking distributions until age 70 1/2. Then, you only take required minimum distributions calculated based on your life expectancy. When you die, you leave the IRA to your spouse, who rolls the balance over to his/her own IRA and names his/her own beneficiaries, perhaps your children or grandchildren. Your spouse delays distributions until age 70 1/2 and then only takes required distributions. When your spouse dies, your children inherit the IRA, which can be divided into separate IRAs for each child. Each child can then take distributions based on each of their life expectancies and can name their own beneficiaries. When your children die, their beneficiaries cannot reset the distributions based on their life expectancy, but the beneficiaries can continue to take distributions based on the previous owner's schedule until the IRA is depleted. By using this strategy and only taking minimum distributions when required, the balance can continue to grow on a tax-deferred basis for years or even decades.

The concept can be expanded further by converting a traditional IRA to a Roth IRA. Although income taxes will have to be paid on any amounts that would have been taxable when

withdrawn (contributions and earnings in a deductible IRA and earnings in a nondeductible IRA), the income taxes can be paid with funds outside the IRA, leaving the IRA balance intact. While your adjusted gross income must be less than \$100,000 (not counting the rollover) to convert, this requirement will be eliminated in 2010, allowing all taxpayers to convert from a traditional to a Roth IRA. Once the funds are in the Roth IRA, you do not have to take any withdrawals during your life. Since your spouse can roll the balance over to his/her own IRA,

he/she would also not have to take withdrawals during his/her lifetime. When your spouse dies, his/her beneficiaries would then have to take distributions over their life expectancies, but qualified distributions could be taken free of federal income taxes.

Don't lose sight of the fact that your IRA's main purpose is to fund your retirement. It should only be used for estate planning purposes if you don't need the funds for retirement. Please call if you'd like to discuss this concept in more detail. ○○○

Plan Ahead

Discussing your personal finances with your children, appointed trustee, or named executor might not be a conversation that you enjoy. However, there are reasons to share at least a small amount of information with the individual(s) whom you appointed to make financial and health-care decisions for you if you are unable to do so yourself.

Some of the information you may want to discuss includes:

- **Where are records kept?** They do not necessarily need to see the documents now, but they should know where they are. These should include insurance policies, investments, deeds, pension information, bank statements, credit card information, and outstanding debt, as well as birth certificates, marriage certificates, and military records.
- **Who are your advisors?** There should be a list with names, addresses, and phone numbers of all advisors and physicians.
- **What are your monthly income and expenses?** This will help them manage your day-to-day expenses. Additionally, information about your health-care coverage will help guide them in making decisions about your care. If you do not wish to expose this information now, tell them where this data can be found.
- **Are your estate planning documents updated?** Does your will and/or trust reflect your current and specific wishes? Do you have a durable power of attorney and a health-care proxy? Do not wait for them to find this document after you lose capacity. They should receive copies now.
- **What if something happens?** If you are unable to physically care for yourself in your own home, where do you wish to go? Discuss preferences for funeral arrangements. If you already prepaid your funeral expenses, ensure the person in charge knows which funeral home you selected.

It will be very stressful for loved ones if you become ill. The more guidance and preparations you make, the better it will be for the family, and the more likely the decisions made on your behalf will be a reflection of your wishes. The best-case scenario is to discuss your plans with all of your children so there are no surprises or secrets. Not only will it give you the best chance of fulfilling your wishes, but it hopefully will eliminate conflict among family members.

If you would like help planning for your future, please call. ○○○

The Basics of QPRTs

The federal lifetime gift tax exclusion was increased to \$1,000,000 in 2002, but is not scheduled to increase in the future. If you're looking for a way to leverage that exclusion while leaving your home or vacation home to heirs, a qualified personal residence trust (QPRT) might be in order.

With a QPRT, you place your home or vacation home in a trust, retaining the right to live in the home for a specified number of years. During that time, you retain ownership and use of the property. When the trust terminates, ownership passes to your beneficiaries. The gift's value is determined by calculating the home's present value discounted over the trust's term using an interest rate specified by the Treasury Department. The higher the interest rate and the longer the trust's term, the lower the value assigned to the gift. Recent interest rate declines generally mean that the gift's value

will be higher than it would have been even a few months ago. However, it's not uncommon for a home to be valued at less than half its value if the trust's term is 10 years or longer.

The gift's value is determined on the date the house is placed in trust. Thus, any future appreciation is removed from your estate. Depending on the gift's value, you may have to pay gift taxes or use a portion of your lifetime gift tax exclusion. If the gift's value would result in the payment of gift taxes, you may want to reconsider this strategy. In those situations, you may want your heirs to receive the home after your death, as long as no estate taxes will be due. QPRTs are irrevocable. If you change your mind later or your family situation changes, you can't undo the trust.

You must outlive the trust's term or the home will be included in your estate at its current fair market value.

You can make provisions for the sale of the home during the trust's term, as long as the proceeds are used to purchase another home within two years.

Your heirs will own the property when the trust terminates, so they should have the financial resources to maintain the property. If you con-

tinue living in the home after the trust terminates, you must pay a fair market rental to your heirs. While that may be a discomfoting thought, it is another method of distributing income to heirs without paying gift or estate taxes.

Your heirs' basis in the home remains the same as your basis plus any gift taxes paid. Thus, if they sell the home with a large capital gain, they may have to pay capital gains taxes. Or your heirs could make the home their primary residence and live in it for at least two of five years before selling. They may then exclude \$500,000 of gain with a married filing jointly status or \$250,000 of gain with a single filing status.

A QPRT can provide a means to remove a home from your estate at a discounted value. Please call if you'd like to discuss QPRTs in more detail.

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains sunset language stating that its provisions will not apply after December 31, 2010. Without further Congressional action, the 2001 tax will be reinstated beginning 2011. ○○○




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