In This Issue:

Should We Worry about the Deficit?
The Basics of Income Taxes
Check Your Property Tax Assessment
Should You Pay Off Your Mortgage by Retirement?
The Case for GRATs
Planning for the AMT

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Should We Worry about the Deficit?

A federal deficit occurs when the government's expenditures for the year exceed its income. The government then pays for those excess expenditures by borrowing money, adding to the national debt. With so much stimulus money being spent to prod the economy out of recession, the federal deficit will reach record levels this year. According to the Congressional Budget Office, the federal deficit will quadruple in 2009, from $459 billion last year to $1.845 trillion for 2009 (Source: *The Economist*, June 10, 2009). While the president vows to slash the deficit in half within four years, the Congressional Budget Office estimates the deficit will still total more than $1 trillion per year by 2019. Are these huge deficits cause for concern? It's tough to decide, since opinions range from "deficits don't matter at all" to "deficits will ultimately result in federal bankruptcy." It might help to put the federal deficits in perspective.

In 1998, for the first time in 28 years, the federal government ran a budget surplus. Those surpluses lasted four years. During that time, concerns about the viability of the Social Security system seemed less urgent, and there was talk about what would happen to the bond market if the federal government paid off all its debt. These discussions were short lived. Following two tax cuts, the September 11 terrorist attacks, the Afghanistan and Iraq wars, and a recession, the federal deficits were back and have not gone away since.

Of course, a federal deficit results in an increase in the national debt.

Continued on page 2

The Basics of Income Taxes

The subject of income taxes is one that most people prefer to ignore. However, since income taxes are a significant expense for most taxpayers, you should come to grips with some basics about taxes:

- **Realize you can exert some degree of control over how much you pay in income taxes.** While you do have to file and pay taxes every year, how much you pay depends on the tax strategies used. Discuss your tax situation with a tax professional, reviewing ways to help reduce your income tax bill.
- **Understand basic tax concepts.** You don't have to become a tax expert, but you should have a basic understanding of the tax laws so you recognize when you need assistance. Before any major financial transaction, review the tax ramifications.
- **Don't make decisions solely for tax reasons.** While you want to minimize the payment of income taxes, that is only one factor in most decisions. You should first make sure the transaction is economically beneficial and then decide how to minimize the tax effects. For instance, perhaps you are considering selling a stock with gains. If you hold the stock for another month, the gain will be subject to capital gains tax rates. However, during that time, the stock's value may go down.
- **Keep good tax records.** During the year, file any records with possible tax ramifications. That way, when it comes time to file your income tax return, all your tax records will be located in one place and you won't forget a deduction. ❍❍❍

FR2009-0908-0096

Should We Worry?

Continued from page 1

Currently, the gross national debt is approximately $11 trillion. A significant portion of that debt is owed to the Federal Reserve and other government accounts. But the public holds $6.8 trillion, or 62%, of the total debt (Source: *Region Focus*, Winter 2009). China and Japan are the largest foreign holders of this publicly held debt.

While the dollar amounts of the deficits and national debt are enormous, these numbers are often presented as a percentage of gross domestic product (GDP) to compare to past deficits and debt levels. The 2009 deficit of $1.8 trillion is 13.1% of GDP, twice the post-World War II record of 6% set in 1983 (Source: *Fortune*, June 22, 2009). The Congressional Budget Office's estimate of a $1.2 trillion deficit for 2019 would represent 5.7% of GDP, an extremely high number for a healthy economy.

In 2008, federal borrowing totaled 42% of GDP, about average for post-war years. By 2019, it could reach 82% of GDP, close to double the current level. At that point, one out of every six dollars the government spends will go to interest payments (Source: *Fortune*, June 22, 2009).

The general consensus is that the government needs to spend money now to stimulate the economy out of the current downturn. Without running deficits, the recession is likely to last longer and become more severe. When recessions cause a rise in unemployment rates, people spend less, which causes more people to lose their jobs, precipitating a downward spiral in the economy. Using short-term deficits to stimulate the economy helps reverse this cycle.

The problem is that even if the short-term deficits lift the economy out of recession, projected increases in Social Security, Medicare, and Medicaid expenditures make it difficult to envision a scenario where the government can operate without deficits. Spending is growing astronomically, while revenues as a percentage of GDP are basically flat. Spending is primarily driven by entitlements such as Social Security, which are projected to grow enormously as the population ages. Revenues, on the other hand, are based heavily on the individual income tax, which typically rises and falls with GDP.

What impact will these huge deficits have on the economy if they continue? No one knows for sure. But perhaps the federal government should pay special heed to what got us into the current recession in the first place — consumers living beyond their means, incurring debt to support a lifestyle they couldn't afford. Will the government be next? ❍❍❍

Check Your Property Tax Assessment

Given the drastic declines in housing values over the past couple of years, it may be time for you to take a second look at your home's assessed value. It's possible that the value isn't accurate, which might entitle you to a reduction in property taxes. To get that reduction, you'll have to officially challenge the assessor's valuation of your home, following these steps:

❍ **Initiate your challenge right away.** You'll have a better chance of winning your appeal if you start it in the same year that you notice the discrepancy between your assessment and your property's market value.

❍ **Start your research in the assessor's office.** Check the records of your assessment and those of about half a dozen homes you believe are comparable. Your chances of a successful appeal are typically greater when you cite several relevant examples. If your community allows you to informally discuss this with the assessor, ask him/her to explain the value he/she currently has on your home in light of market conditions and other assessments you've looked at.

❍ **Know your municipality's appeal procedures.** What are the deadlines for an appeal? What forms do you need to fill out? How much does the local government charge for an appeal, and when is it due? You don't want your case thrown out over a technicality.

❍ **Look for errors in the assessor's report.** Many assessments are conducted on a "drive by" basis, with the assessor never leaving his/her car and referring to existing records, which may be inaccurate or out of date. Check the figures used for such details as square footage and the number and types of rooms. Does the report accurately indicate such improvements as a finished basement or attic? Have you made any alterations that could have reduced the home's value, like taking down a deck or removing a swimming pool?

❍ **Secure an independent appraisal from a respected professional.** The closer the appraisal is to the date of your appeal hearing, the more effective it will be in supporting your case. ❍❍❍

Should You Pay Off Your Mortgage by Retirement?

A recent study found that 41% of homeowners between the ages of 60 and 69 still have a mortgage on their home. Of those, 51% had sufficient assets to repay their mortgage (Source: Center for Retirement Research, July 2009). The study found that most households would be better off paying their mortgage off. But is that good advice for your situation? Before making this decision, be sure to consider these factors:

❍ **Compare your mortgage interest rate to the rate you are earning on your investments.** If you retain your mortgage because you believe you will earn more on your investment assets, make sure that is really happening. When paying off a mortgage, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk.

❍ **Consider the tax benefits of the mortgage interest.** Interest paid on mortgages with balances of up to $1,000,000 and on home-equity loans up to $100,000 is deductible on your federal tax return, provided you itemize deductions. You only benefit if your total itemized deductions exceed the standard deduction amount, which in 2009 and 2010 is $11,400 for married couples filing jointly and $5,700 for single taxpayers. Even if you do itemize deductions, you are paying most of the interest.

❍ **Pay off consumer debt first.** Consumer debt typically carries higher interest rates than mortgage rates, and interest payments are not typically tax deductible, unless it's a home-equity loan.

❍ **Consider which funds you would use to pay off the mortgage.** If you are planning to use tax-deferred monies, such as those in a traditional IRA or 401(k) plan, to pay off your mortgage, those withdrawals could be subject to income taxes, which will impact your decision to pay off the mortgage. Financially, it is typically better to use taxable accounts to pay off your mortgage.

❍ **Retain some savings.** You don't want to use so much of your investment assets to pay off your mortgage that you have difficulty paying for unexpected expenditures.

Please call if you'd like help deciding whether you should pay off your mortgage before retirement. ❍❍❍

The Case for GRATs

The lifetime gift tax exclusion is $1,000,000, but it is not scheduled to increase in the future. If you'd like to pass on more than $1,000,000 to your heirs before your death but don't want to pay gift taxes, you may want to take a look at grantor retained annuity trusts (GRATs).

With a GRAT, you transfer an asset to the trust, retaining an annuity interest for a specified term, typically two to five years, but sometimes longer. During that period, the trust pays you a specified amount every year. When the trust terminates, the property goes to the named beneficiary. The gift is valued based on the present value of the remainder interest, which is the property's value less the retained annuity interest's value. Any appreciation in the asset after transfer to the trust escapes gift and estate taxes. However, if you die before the trust ends, the trust property will be included in your taxable estate.

Recent declines in interest rates have made GRATs a more valuable estate planning strategy for a couple of reasons. When you initially place the asset in the trust, the lower interest rates will result in a lower value for your retained interest, thus reducing the gift's value. When your annuity payments are calculated, lower interest rates will result in a lower required annuity, leaving more assets in the trust for your beneficiaries. The interest rate that must be used for these calculations is 120% of the midterm applicable federal rate, which was 3.16% for December 2009 (Source: *Federal Taxes Weekly Alert*, November 19, 2009).

Assets that are typically good candidates for a GRAT are those whose value is expected to increase significantly during the trust's term. GRATs are sophisticated estate planning tools that may only be appropriate in certain situations. Please call if you'd like to discuss GRATs in more detail. ❍❍❍

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Planning for the AMT

The alternative minimum tax (AMT) was originally designed to ensure wealthy taxpayers paid at least a minimum amount of tax. However, due to the tax calculation, more and more middle income taxpayers are becoming subject to the AMT. Almost four million taxpayers paid the AMT with their 2006 tax returns, with that number expected to grow to 32 million by 2010 (Source: *The Milken Institute Review*, 4th Quarter 2007).

While you might think it is taxpayers with complicated tax returns who are subject to the AMT, the most significant preference items in 2006 were state and local taxes (63% of all AMT preference items), personal exemptions (22% of all AMT preference items), and miscellaneous itemized deductions (11% of all AMT preference items) (Source: *The Milken Institute Review*, 4th Quarter 2007).

Why are so many taxpayers subject to the AMT? One of the main reasons is that ordinary income tax brackets are adjusted for inflation annually, while the AMT exemption amounts are not adjusted. Another reason is that regular income tax rates were reduced recently, while the AMT tax rates remain the same.

How is the AMT calculated? As its name implies, the AMT is an alternative way to calculate your income taxes. You start with your taxable income and add back several items, including personal exemption deductions; the standard deduction; state, local, and property tax deductions; medical expenses, unless they exceed 10% of AGI; miscellaneous itemized deductions; interest on home-equity loans and lines of credit not used for home improvements; municipal interest income from certain private-activity bonds; certain business-related items if you own a business, rental property, or interest in a partnership or S corporation; and the difference between the market price and exercise price of incentive stock options.

From this calculation, you subtract the AMT exemption amount, which in 2009 is $70,950 (up from $69,950 in 2008) for married taxpayers filing jointly and $46,700 (up from $46,200) for single taxpayers. The result is then subject to the AMT rates — 26% on the first $175,000 of income and 28% on amounts over that. If the AMT exceeds your regular income tax, the difference must be paid as the AMT. If you pay the AMT, some portion of that tax may be refunded in future years through an AMT credit that offsets your regular tax liability. However, the credit can only be used in years when you don't pay the AMT.

How can you plan for the AMT? Since so many items affect the AMT calculation, it's difficult to determine who will be subject to the tax. Consider these strategies:

- **Accelerate income and postpone deductions.** In years when you are subject to the AMT, you will typically pay less tax by postponing deductions (many of which are added back in the AMT calculation) and accelerating income.
- **Review the timing of significant capital gains.** Although long-term capital gains are still subject to a maximum income tax rate of 15% under the AMT, recognition of those gains may cause other income to be taxed at higher rates.
- **Plan incentive stock option exercises carefully.** For AMT purposes, the difference between your exercise price and the market price on the date of exercise is considered an AMT preference, even if you don't sell the stock or the value decreases after exercise. You might want to exercise stock options early in the year. Then, near the end of the year, you can sell the stock if the price goes down so you won't be subject to the AMT on the option exercise.

Please call if you'd like to discuss the AMT in more detail. ❍❍❍

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