

CPA

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OCTOBER 2009

Client Bulletin

BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

Naming a Quarterback for Your Estate's Game Plan

When you develop your estate plan, you should do more than determine how your assets will be distributed at your death. You'll have to rely on someone to carry out your wishes efficiently. You should choose a competent person, certainly, but you also should choose someone who can be trusted to act in the best interests of all your beneficiaries.

Electing an executor

In your will, you'll designate an executor to handle the transfer of your assets to one or more recipients. This person may be known as the administrator or personal representative. By any name, your executor will be responsible for locating your assets, distributing them per your expressed wishes, paying off any debts you leave behind, filing tax returns, etc.

If you're married, you probably will consider naming your spouse as executor of your estate. In fact, your spouse might be upset if you choose someone else. However, you could be making a mistake if you designate your spouse. In many cases, a surviving spouse is so distressed by the death of a husband or wife that she or he can't fulfill all of an executor's responsibilities. What's more, if your spouse is about your age and you live beyond official life expectancy, your survivor may be physically or mentally frail when it's time to serve as your estate executor.

Often, an adult son or daughter is a better candidate for estate executor. Other possi-

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Did You Know?

Through the first half of 2009, U.S. stock funds had average annualized returns of 0.45% for the prior 10 years. During that period, taxable bond funds had average annualized returns of 4.34%.

Source:
Morningstar

CPASM

America Counts on CPAs

bilities include siblings, nieces, nephews, or close friends. Pick someone who lives nearby because your executor may be dealing with local banks and courts.

In many instances, the executor doesn't have to be knowledgeable about legal or financial matters. He or she should be good with paperwork and reliable in carrying out responsibilities. Also, an executor who gets along well with your beneficiaries may be adept at dealing with any conflicts that arise as your will's terms are implemented.

Money matters

If you expect to have an estate that runs into seven figures, you may decide to choose an executor who is financially savvy as well as detail oriented and congenial. With a sizable estate, an executor might have to explain a disclaimer option to the surviving spouse or make an election so that assets left in trust will escape estate tax. An executor may have to hire a reputable appraiser in order to justify a low valuation of illiquid assets for estate tax purposes.

Whomever you choose, make sure your executor is well prepared. Review your assets with the individual you've selected so that he or she knows what you have and where those assets are kept. Try to get your records organized and let your executor know where to find the paperwork.

Do you need to arrange payment for your executor? Perhaps not, if your estate is fairly simple. However, if your executor is expected to do a great deal of work and won't be a major beneficiary of your estate, you may want to provide for some compensation in your will. This could be a flat fee, hourly

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fee, or specified percentage of trust assets.

If your estate is large enough to owe estate tax and the executor will be a major beneficiary, consider paying him or her as large an amount as you can justify. Your executor might owe income tax at rates up to 35%, under current

law, but your estate could deduct the fees it paid. Estate tax rates are now 45% on amounts over \$3.5 million, so the estate would get a tax deduction worth 45 cents for each dollar it paid out. If future tax rates are similar to those in effect today, the estate tax savings will be greater than the income tax cost.

Finally, don't rely on one potential executor. Always name one or more backups in case your first choice is unable or unwilling to serve. And be sure to get the consent of possible executors before naming them in your will.

Surprisingly, Mortgage-Backed Securities Can Be Safe

Many people trace the current financial troubles to residential mortgages. Default rates have risen and investors in some mortgage-backed securities have had difficulty selling them. Major financial firms have had huge losses because of unwise commitments to mortgage-backed securities.

Paradoxically, some investors in mortgage-backed securities have thrived recently. Vanguard GNMA Fund, for example, invests solely in mortgage-backed securities. It returned over 7% in both 2007 and 2008, followed by a 2.5% return in the first half of 2009. American Century Ginnie Mae, Fidelity Ginnie Mae, T. Rowe Price GNMA, and USAA GNMA funds all have similar holdings and posted similar results, give or take a percentage point. Although those returns were not spectacular, they would have been welcomed by many investors who lost heavily in 2008.

Ginnie Mae is the popular name for the Government National Mortgage Association, often abbreviated as GNMA. Ginnie Mae guarantees investors the timely payment of principal and interest on securities backed by loans that are insured or guaranteed by the Federal Housing Administration and other federal agencies.

Many such loans are packaged into securities that are sold to investors. Consequently, when Hank Homeowner makes a payment on his 6% home

mortgage, the payment eventually finds its way into the pockets of investors holding those securities. The securities, known as Ginnie Mae pass-through certificates, are backed by the full faith and credit of the U.S. government. There's no credit risk to investors, so Ginnie Maes haven't suffered from the rising default rate on home mortgages.



The result is that Ginnie Mae mortgage-backed securities have the same credit quality as U.S. Treasury bonds. Yet Ginnie Maes pay higher yields to investors. As of this writing, intermediate-term Treasury securities with maturities in the 5- to 10-year range pay around 2.5%–3.5%. Ginnie Maes with comparable duration yield 3.5%–4.5%.

Safety in numbers

You can buy Ginnie Maes through a broker. There may be complications, however. As explained previously, a Ginnie Mae investor essentially holds a small piece of many mortgage loans. When each homeowner makes his or her monthly payment, the money flowing through to investors includes some principal along with the mortgage interest. As mortgages are refinanced or redeemed when homes are sold, investors collect large chunks of repaid principal.

If you invest in a Ginnie Mae pass-through certificate and treat each payment you receive as money you can spend, you'll spend a partial return of your original principal as well as the interest income from your investment. Alternatively, if you attempt to invest the partial returns of your original principal as you receive them, you'll be dealing with irregular amounts that may be hard to place in desirable investments.

Such concerns, as well as the complexity of the mortgage-backed securities market, have led many investors to participate through mutual funds. There are many funds from which to choose. Some invest only in Ginnie Maes; others also invest in securities issued by Fannie Mae and Freddie Mac, government-sponsored enterprises with implicit federal support.

When you invest in this type of fund, you own many high quality mortgage-backed securities. Your returns of principal are automatically reinvested in similar securities, and you can choose to have interest income reinvested as well. Current yields are around 4.5%.

Negative thinking

There must be a reason why Ginnie Mae funds pay 4.5% when mutual funds holding Treasuries pay around 3.5%. There is: Investors in Ginnie Mae funds receive higher yields to compensate them for these funds' higher risk. Ginnie Maes face risk both when interest rates rise and when they fall.

When interest rates rise, the market value of Ginnie Maes decreases. A fund yielding 4.5%, for example, becomes less valuable when investors can get 5% elsewhere. Investors who sell when interest rates rise may experience a loss. On the other hand, if interest rates fall, homeowners may refinance their mortgages—paying off their original mortgages. Lower interest mortgages replace higher interest mortgages, and Ginnie Mae funds' returns drop. In addition, the funds receive large influxes of cash from the prepayments of original mortgages that they must reinvest at lower rates.

Over long time periods, Ginnie Mae funds have posted total returns higher than funds focusing on intermediate-

term Treasury bonds. There's no guarantee that this will be the case in the future, but the history of Ginnie Mae funds indicates they may offer relatively high yields along with safety and stability.

If you invest in Ginnie Maes or Ginnie Mae funds, the interest is fully taxable. In contrast, the interest from Treasury securities is exempt from state and local income tax. Therefore, if you invest in Ginnie Maes, you might prefer to hold them in a tax-deferred account such as an IRA.

Gifts to Trusts Must Be Handled With Care

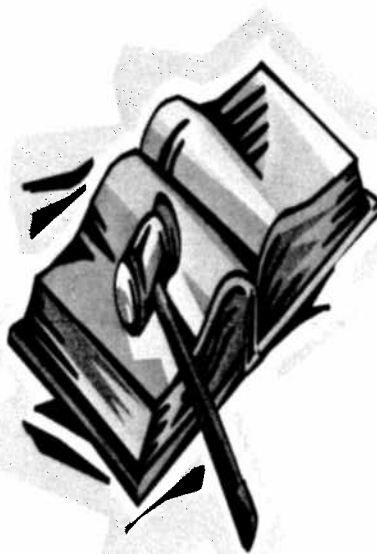
You can reduce your beneficiaries' exposure to future estate tax by giving away assets you don't need. Those assets and any future appreciation will be removed from your taxable estate. Giving money to your daughter Kristi can be a simple process. But what if Kristi is young and you feel she'll be tempted to spend that money unwisely? Or what if Kristi is married to someone you fear will gamble away your gifts? For any number of reasons, you might prefer to put money into an irrevocable trust for Kristi rather than make an outright gift to her.

Dealing with the gift tax

Unfortunately, transfers to an irrevocable trust may not qualify for the annual gift tax exclusion, which is \$13,000 per recipient in 2009. To qualify, such gifts must offer a "present interest." That is, the recipient must be able to get his or her hands on the asset. However, often the reason for making gifts in trust is to keep the assets out of the trust beneficiary's easy reach.

If you give \$13,000 to an irrevocable trust for your daughter, that transfer

may trigger gift tax. You might have to file gift tax returns and, if you already have used up your \$1 million gift tax exemption, you might have to pay



gift tax at a rate of 45% of the amount transferred.

To make gifts in trust and avoid gift tax consequences, you can follow the "Crummey" procedure. This process is

named after a precedent-setting court decision in which the taxpayer prevailed over the IRS. Here is how the Crummey procedure might work:

Example: Ben Richards creates an irrevocable trust and names his two children as trust beneficiaries. Ben names his sister Meg, a CPA, as the trustee. Ben transfers \$26,000 into the trust. Meg sends notices to both trust beneficiaries that state they have 30 days to withdraw up to \$13,000 apiece.

Therefore, both beneficiaries have the opportunity to access the assets transferred to the trust. This gives them a present interest in the transfer and qualifies the gifts for the annual exclusion. After 30 days, if no withdrawals have been made, the \$26,000 can stay in the trust or be used by the trustee, with no gift tax consequences.

If Ben's wife Lara joins in the gift, the couple can move up to \$52,000 worth of assets (twice \$26,000) into the trust this year, tax free.

Permanent Life Insurance Offers Tax Benefits

When you buy life insurance, you may be better off with term coverage. Term life policies have relatively low premiums because they pay only if the insured individual dies during a certain time period. You might buy a 20-year term policy, for instance, to protect your family until your children are grown. However, term insurance might not be ideal for an indeterminate need.

Example: Ken Collins wants to leave his family business to his daughter Amanda, his chosen successor. He also wants to provide for his other daughter Melanie. To equalize their inheritances, Ken buys \$1 million of insurance on his life, payable to Melanie. Ken doesn't know when he'll die, so he buys permanent life insurance.

Cash accumulation

You'll pay much higher premiums for a permanent life policy than for a term policy. Some of the money you pay will go into an investment account, often known as the policy's cash value. The cash value is designed to accumulate and provide funds for increasing life insurance charges as you grow older.

Among permanent life insurance policies, there are three main types: whole life, variable life, and universal life. All of these varieties offer three tax benefits.

- **Income tax-free death benefits.** At Ken Collins' death, Melanie will collect \$1 million from the insurance company. She won't owe any income tax on that \$1 million. Term life pay-outs get the same tax treatment.

- **Tax-deferred accumulation.** As mentioned, permanent life policies differ from term life policies because the former include a cash value account. If the cash value generates income, as planned, that income won't be subject to income tax.
- **Tax-free loans and withdrawals.** When you own a permanent life policy, you may take withdrawals and loans. Withdrawals are not taxable up to the amount you have paid in premiums. You also may avoid taxes on policy loans as long as the insurance policy retains enough cash value to satisfy IRS rules. You should be aware that any withdrawals or loans probably will reduce the policy's cash value and death benefit.

Tax Calendar

OCTOBER 2009

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2008, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalty due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2008 calendar year tax return (Form 1065-B).

your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than \$500.

November 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

November 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

NOVEMBER 2009

November 2

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2009. Deposit any undeposited tax. (If

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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Family documents checklist

This family documents checklist from Winthrop Mutual Funds is a good starting point. Make any necessary additions and skip items that don't apply. You should make sure the items on the list are easy to find, ideally organized in a fireproof filing cabinet or home safe. Winthrop suggests you complete the checklist — listing locations and comments for each item — and send copies to the executor of your estate and to key family members.

✓ Emergency papers and information

- Organ donor/ anatomical gift statement _____
- Burial instructions, cemetery plot deed, prepaid cremation documents, preferences of funeral home, cremation or burial, donations. _____
- Key adviser and contact phone numbers, addresses. _____
- Lawyer, stockbroker, financial planner, etc. _____
- Last will and testament _____
- Living will/health care proxy _____
- Military discharge papers and other records _____
- Powers of attorney/ durable powers of attorney _____
- Safe and combination _____
- Safe deposit box and keys _____

✓ Nonfinancial personal papers

- Adoption papers _____
- Birth certificate _____
- Citizenship or naturalization papers _____
- Divorce/separation papers _____
- Driver's license number and expiration date _____
- Marriage certificate, prenuptial agreement _____
- Passport number and expiration date _____
- Social Security card _____

✓ Investment documents

- Annuity statements and policy documents _____
- Bearer bonds, for which coupons are clipped for redemption _____
- Brokerage account statements (include IRAs, KEOGHs, etc.) _____
- Investment club agreement _____
- Retirement plan statements _____
- Stock certificates not held in an account _____

✓ Financial personal papers

- Appraisal or inventory of valuables _____
- Automobile titles _____
- Buy/sell or partnership agreements _____
- Employer deferred compensation agreement documents _____
- Federal/state gift-tax returns _____
- Income-tax returns from prior years _____
- Lawsuit or legal-actions-pending documents _____
- Loans outstanding or debts owed to you (promissory notes) _____
- Mortgage documents _____
- Prescription plan card/records _____
- Property tax and school tax records _____
- Real estate deeds, other titles of ownership _____
- Rental or lease agreements _____
- Trust agreements _____

✓ Bank and credit accounts

- Bank and credit union account statements and books, statements for individual retirement accounts, KEOGHs, etc. _____
- Checks from checking or money market accounts _____
- Credit cards, account statements _____
- U.S. savings bonds _____

✓ Insurance documents

- Group life and retirement policies (booklets, certificates) _____
- Health and accident insurance ID cards and claim records _____
- Life insurance policy documents _____
- Mortgage insurance policy _____
- Property and casualty policy documents (homeowners, auto, boat, etc.) _____
- Travel insurance policies _____
- Veterans administration insurance papers _____

THE ESSENTIALS

Here are the key legal documents you will need—aside from a will, of course—to assist parents in a medical or financial emergency and handle their estate at death

MEDICAL DIRECTIVE

Also known as a living will or advance health-care directive, it lays out the kind of care your parents want if they become ill or incapacitated

DURABLE POWER OF ATTORNEY FOR HEALTH CARE

Gives you authority to make health-care decisions for your parents. Also referred to as a health-care proxy

PRIVACY RELEASE

A release, under the Health Insurance Portability & Accountability Act, authorizes access to your parents' medical records

DURABLE POWER OF ATTORNEY FOR FINANCES

Lets you manage your parents' finances, including paying bills or selling property

REVOCABLE LIVING TRUST

Enables parents to retain control over their estate while transferring assets to beneficiaries