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New Study Shows Future Impact Of Great Recession

It was dubbed the Great Recession, and by any measure, the economic downturn that officially ended in June 2009 has been financially wrenching for almost everyone. Millions of jobs were lost, wages remain stagnant for those who were able to keep working, and poverty rates have soared. More than two years after the economy bottomed out, unemployment continues to hover at around 9% and growth in the U.S. gross domestic product still hasn't hit its post-recession stride.

The impact of the Great Recession will resonate for years to come, especially as it relates to retirement savings. Many people were forced to tap retirement plan accounts to weather the economic storm, and those who weren't working lost ground in accruing Social Security benefits. Supported by a grant from the Social Security Administration, the Center for Retirement Research at Boston College released an executive paper in May 2011 summarizing the impact of the Great Recession on future retirement income. It projects average incomes for adults who were between the ages of 25 to 64 in 2008 and compares the results to what people might have received had the recession not occurred. Consider these key findings.

1. The Great Recession will reduce future retirement income across the board, but it hits hardest at young workers and high-income earners. Adults between age 25 and 34 in 2008 can expect to see their income at age 70 be 4.9% lower (an average of $3,000 per person) as a result of the economic slowdown. Younger workers were more likely to lose their jobs than were older employees during the recession, and the impact of their missing retirement savings is magnified by the decades the money would have had to compound.

2. Older workers, however, are not immune to the impact of the recession. The income at age 70 for those who were 55 to 64 in 2008 is expected to decline by 4.1%, mainly because they'll receive less in Social Security benefits. Job losses and wage stagnation during the recession negatively affects the Social Security benefit formula for those who turn 60 after 2008. Also, those who were near retirement age during the recession and were laid off are statistically unlikely to rejoin the work force. Relatively few adults return to work if they become unemployed in their early 60s.

3. In absolute terms, those with the highest incomes will experience the greatest decline in retirement income. For example, younger workers in the top income quintile can expect to lose $7,500 per person annually, while those in the bottom quintile are projected to lose only $400 a year. Reduced earnings will further limit future income from pensions, retirement accounts, and other assets. Statistically, workers in lower-income groups won't fare as poorly, but only because they are less likely to have retirement plans

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PWM Wealth Builder And Beyond

The year 2012 is moving right along. As the world evolves, the financial challenges' facing our clients evolve too. Jason Mirabella has been instrumental in creating a process that will help us see more, know more and do more for our clients. It's called Wealth Builder. Wealth Builder is designed to get our clients financially organized, identify opportunities for improvement, and manage throughout life. We look forward to an individual consultation with each of you as this year progresses.

And what is beyond ... ? Due to the growth that PWM has experienced and the level of service we intend to continue to provide, we have reorganized the firm. Dan Sommers, CPA, CFP, who has been an invaluable asset for over 12 years now, has been designated Managing Director of Client Experience. Jason has been promoted to Director of Analytics. I am confident their leadership will enhance your PWM experience.

Don't be surprised if you see some additional faces as the year progresses. I hope 2012 has started out well for you and it brings you all the blessings you deserve!

John

Don't Be Trapped By Another State's Tax

Do you own a second home in a resort area that you use personally or occasionally rent out? You could be in for a rude surprise at tax time, if the state where the home is located insists you're a legal resident and must pay income taxes. In some cases, that may trigger hundreds of thousands of dollars of extra tax liability.

Several states, including Arizona, California, Hawaii, and New York, have been challenging the assertions of homeowners who claim to live out of state. A state may maintain that the owners actually reside within its borders, even if they consider the dwelling to be a vacation home. With other cash-strapped states taking notice of these tactics, the trend may well continue and expand.

In one high-profile case, John J. Barker, a Wall Street investment manager, and his wife argued that they were Connecticut residents who made only sporadic visits to a second home near the exclusive Hamptons area of New York. During the tax years that a New York state audit brought into question—2002 through 2004—the Barkers said the home was used by other family members. But the couple spent more than half of each of those years in New York, and the state has assessed a tax bill of more $1 million for the three years and tacked on penalties of around $220,000. The Barkers have appealed the ruling but may eventually have to pay at least part of the bill.

In another recent case, media personality Martha Stewart, too, argued that her legal residence was in Connecticut and her place in the Hamptons was just a second home. But New York prevailed and Stewart had to pay almost $222,000 in back taxes.

The Empire State has a reputation for being one of the toughest states for audits, and it often targets residents of states such as Florida, Nevada, and Texas that have no income taxes. But farmers in the heartland and jet setters up and down both coasts face similar problems. In the worst-case scenario, you could even be hit by taxes from two states on a single property.

You may be able to avoid trouble if you clearly establish your residency in a single state of your choosing. Because residency laws vary from state to state, you'll have to research the method for documenting your legal domicile. At the very least, obtain a driver's license, register to vote, and file your income tax returns in your home state. Other things that generally help evidence where you live include memberships, where you receive you mail and maintain your bank accounts, and where you register your vehicles. And be sure to keep detailed records of your whereabouts, including a summary of frequent-flier accounts, credit card receipts documenting trips between homes, and phone records that you could use to bolster a claim of residency (or of non-residency). ●

Start Estate Planning For Your Child Now

You may already have had a power of attorney drafted that lets you act on behalf of elderly parents. And it's possible you have estate planning documents dealing with the possibility that you or your spouse could become incapacitated. But what about your college-age children?

That's not as crazy as it may sound. Once a child becomes an adult under state law, you may have to rely on the following documents to enable you to make important medical and financial decisions for your son or daughter.

Health care proxy. Under the landmark Health Insurance Portability and Accountability Act (HIPAA), parents may not have access to their children's medical records even in the case of a serious accident or illness. HIPAA generally prohibits medical providers from revealing confidential information about their patients. However, a health care proxy can give parents the access they need. This document allows a child to designate someone—usually a parent—to make health care decisions on the child's behalf in case of physical or mental incapacitation. Such decisions may include approving treatment options and medications. If you establish a health care proxy with your child, be sure to provide copies to the college health services and to the child's primary physician.

Durable power of attorney. This document ensures ongoing management of the financial affairs of a child who's unable to take care of those matters. Typically, such a document designates a parent as "attorney-in-fact," so that if a child becomes incapacitated, the parent can step right in. For example, you might need to take action relating to investments, bank and credit card accounts, leases, student loans, tax filings, and the like. A durable power of attorney could also let you take

New IRS Data Indicates Audit Triggers

The IRS issues vital tax statistics about individuals and businesses in its annual "Data Book" (also referred to as Publication 55B). The latest edition, covering the federal government's 2010 fiscal year—from October 1, 2009 through September 30, 2010—was released in March 2011 and reveals the latest patterns in the tax agency's enforcement efforts. Studying those trends can show what activities and circumstances may be most likely to put you at risk of a tax audit.

Not surprisingly, businesses and individuals generating the highest incomes are most likely to be targeted. But the IRS also continues to examine some taxpayers at all income levels to keep anyone from feeling audit-proof. Consider these key findings from the 2010 Data Book.

Types of audits. There are two main types of audits: correspondence audits, in which a letter from the IRS requests additional information about a return; and field audits, which tend to be more thorough and may be conducted by an IRS agent in your place of business, your tax advisor's office, or in IRS offices. Almost 80% of the audits in 2010 were correspondence audits, a slightly higher percentage than in 2009.

In most cases, an audit will begin with a letter that raises questions about particular items on a return. If issues under dispute are complex, the IRS may launch a closer examination of your personal or business records. But even most field audits are targeted to a specific area, and it's rare for an entire return to be called into question. A return may have been flagged for investigation because of an entry on a specific line or a combination of two or three lines. If you do end up being audited, be forthright with the IRS agent but don't volunteer information. As a practical matter, the agent will want to close the case as quickly as possible.

Audit rates. The overall audit rate for individual tax returns in 2010 was 1.1%. That means that about 1.6 million of a total 143 million individual tax returns were audited. But the likelihood of being asked for more information varied widely according to income level, type of return, and tax benefits claimed. For returns showing total positive income (TPI) of $200,000 to $1 million, 2.5% of returns not showing business activity were audited (up from 2.3% in 2009), while 2.9% of returns showing business activity were audited (down from 3.1%). For returns with TPI of $1 million or more, 8.4% were audited, compared with 6.4% the previous year.

Frequently, an individual return is audited because a particular line item "jumped out" as being sharply different from normal levels. Frequent triggers include unusually high deductions for mortgage interest, charitable donations, or medical expenses.

Business returns. For businesses (not including farms) that brought in total gross receipts of $100,000 to $200,000, 4.7% of returns were audited in 2010 (up from 4.2%). For businesses (not including farms) with total gross receipts of $200,000 or more, 3.3% of returns were audited in 2010 (up from 3.2%). The audit rate for all corporate returns, excluding those of S corporations, was 1.4% (up from 1.3%). For partnership and S corporation returns, the audit rate was 0.4% (virtually the same as in 2009).

Mathematical errors. The IRS caught about 10.5 million math errors on 2009 returns. Of these, 60.8% were attributable to the Making Work Pay Credit, 9% were for calculating other taxes, 4.9% were related to personal exemptions, and 1.3% were related to the first-time homebuyer tax credit.

Penalties. The IRS assessed 27.1 million civil penalties against individual taxpayers in the 2010 fiscal year (up from 26.4 million a year earlier). Of these, 57.3% were assessed for failure to pay taxes, 27.3% were for underpaying estimated taxes, and 13% had to do with delinquent payments. For businesses, 145,931 civil penalty assessments were made (up from 970,098 in 2009). Of those, more than four in 10 were for failing to pay taxes or underpaying estimated taxes.

Criminal cases. The IRS launched 4,706 criminal investigations in 2010 (up from 4,121 the previous year). This resulted in 3,034 referrals for prosecution (up from 2,570). Of those who lost criminal cases, 81.5% ended up being incarcerated (up from 81.2%).

These statistics and trends can't protect you from an IRS audit, but they do point toward potential trouble spots, and underscore the importance of minimizing mistakes on your return. ●

care of things stateside while your child goes abroad for education. Be sure to give copies to your child's school, the financial aid office, and other relevant parties.

Wills and trusts. Though many college-age children may have no need for a will, it's a sensible precaution for those with substantial assets. A will and perhaps a trust can help avoid having assets revert to the parents if a child should die—a transfer that could complicate the parents' estate plans. Trusts can be efficient tools for sending wealth directly to a sibling or to another relative, and assets held in trust are also exempt from probate. Finally, a will and trusts could be structured to minimize potential estate taxes.

If a child becomes incapacitated without a health care proxy or durable power of attorney in place, the family may be forced to pursue a guardianship or conservatorship arrangement. That can be costly and time-consuming—and easily avoided by establishing these few essential estate planning documents. ●

A Once-In-A-Lifetime Estate Tax Choice

If a family member died in 2010, you can take advantage of a unique estate tax planning opportunity. You could use the estate tax provisions in place before passage of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010. Or you may employ the revised rules of the new law. Making the right choice could result in big tax savings.

Under a 2001 tax law, the estate tax was eliminated for 2010 only. Yet while that should be an obvious advantage for the estates of those who died that year, there's a catch. Before 2010, people who inherited stocks or similar assets got a break on capital gains, because the cost basis of such assets, for tax purposes, was "stepped up" to the assets' value at the death of the person making the bequest.

Cost basis is the original value of an asset for tax purposes (usually purchase price), adjusted for stock splits, dividends, and return of capital distributions. For assets inherited in 2010, inheritors must use the original cost basis, adjusted by two exceptions:

- The basis of assets transferred to a surviving spouse may be increased by $3 million.
- The basis of assets transferred to any beneficiary may be increased by $1.3 million.

Suppose a son or daughter inherits stocks worth $4 million that have a cost basis of $1 million. Under the original rules for 2010, the new cost basis would be $2.3 million—$1 million plus $1.3 million. (Because surviving spouses get to add together both breaks, they wouldn't be hurt by the rule change in this example.)

The new estate rules established by the 2010 Tax Relief Act let inheritors exclude $5 million from estate tax, and the top tax rate for assets exceeding that exemption is 35%. Those provisions, in effect for 2011 and 2012, are accompanied by a return to the rules providing a full step-up in basis for inherited assets.

The new tax law actually lets you choose which rules will govern an inheritance from someone who died in 2010. You can opt for no estate tax and the more restrictive rules on the cost basis of inherited assets, or you can retroactively apply the new rules.

Which is more advantageous? Suppose your father died in 2010 and you inherited his estate consisting of $6 million in assets with an original basis of $2 million. After deducting the $5 million exemption, you owe estate tax of $350,000 under the new rules (35% of $1 million). But the assets' basis is stepped up to $6 million, and you won't owe capital gains tax if you sell them for that price.

And under the old rules? You'd pay no estate tax, but you'd owe $405,000 in tax on the capital gains. The cost basis would be $3.3 million—the original $2 million plus the $1.3 million increase—leaving you with a gain of $2.7 million taxed at 35%. So in this case, you'd save $55,000 by choosing the new rules. ●

Impact Of Great Recession

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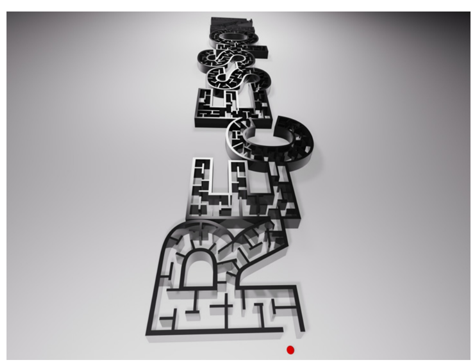
and tend not to be able to save much, even during the best of times. Relatively speaking, however, high-income groups won't lose much more than lower-income groups because the large absolute losses of the high earners account for a smaller share of their overall income.

4. The decline in household income caused by the Great Recession will increase the number of people living on limited incomes at age 70. For those who were between the ages of 25 and 64 in 2008, the share of incomes below 125% of the federal poverty level at age 70 will increase by 7.4%, putting an extra 711,000 adults in or near poverty.

The Boston College researchers acknowledge that creating income projections for the next 40 years is an inexact science, and future events could significantly alter the outcomes their report predicts. For instance, an unusually long stretch of continued unemployment could have a negative impact on workers and result in even worse scenarios. Alternatively, average wages could rebound to levels that prevailed before the Great Recession, thereby offsetting more of the recession-related losses.



The downturn might also encourage workers to change spending habits and focus more on retirement savings. Of course, such changes are less likely for older unemployed workers already near retirement.

Though statistical averages are interesting, your situation is unique, and even if you lost ground during the Great Recession, it's not too late to resume saving and planning for a rewarding retirement. We can help you assess your situation and make the adjustments you need to get back on track. ●