Reorganizing the Balance Sheet: How Millennial Professionals Can Take Advantage of Government Tax Breaks

By: Jonathan D. Morton

Many millennials carry heavy student debt burdens, but there are tax-advantaged strategies that some may employ to better take advantage of the Internal Revenue Code. The term “millennial” has become almost a bad word among generation-xers and their baby boomer parents, used to describe the generation born between 1980 and the mid-2000s. Sometimes characterized as entitled, self-centered and needy, the millennial generation now makes up over one-third of the population of the United States; the largest generation. The generation provides the U.S. labor market with 53.5 million workers, also the largest in the nation. Yet, nearly half of all millenials entering the work force, and nearly 70% of those with college degrees, are burdened with heavy debt loads – the average student debt burden is ~ $29,000 per person.

Millenials are the most educated generation in United States history, with at least 61% having attended college, compared to only 46% of their parents. Many in the maligned generation entered the labor force in the midst of one of the worst recessions in United States history and unemployment among the generation remains high. The result is a highly educated, yet underemployed generation grappling with financing their education. To illustrate, according to the USA Today total student loan debt in the U.S. now exceeds $1.2 trillion. Of course, the debt burden has manifested itself in the housing market as home ownership among the generation has fallen to 36.2%, the lowest level among their cohorts since the United States Census Bureau began the survey in 1982. Though, for those professionals that have moved out of mom and dad’s basement and into their own home, there are some important strategies that can be utilized to save on student loan spending.

Student loan interest, especially among graduate students, is expensive. Since 2006, and despite historically low federal funds rates, graduate loans have averaged between 6.8%-8.5%. Importantly, these rates are fixed and cannot be refinanced through the world’s largest student lender, the United States government. A married couple, each with a graduate degree, is likely to start out with $105,000 of student loan debt (2014 average). That couple is likely paying at least $7,140 in interest per year, without any payment towards principle. Unfortunately for that couple, they are limited to a total tax deduction of only $2,500. Had they not gotten married, they would each have been able to deduct $2,500, for a total of $5,000; but because they got married – only $2,500. It gets worse. As soon as that married couple exceeds $130,000 in joint income, the deduction begins being phased out, with a total phase out at $160,000 of income.

Importantly, the tax code provides big benefits for home ownership. A couple can deduct home mortgage interest on a home worth up to $1 million, and can deduct interest on home equity lines of credit up to $100,000. Home mortgage debt is much cheaper than student loan debt; currently around 4.0% or lower for a 30-year fixed mortgage. Therefore, a $100,000 home equity line of credit costs $4,000 per year, nearly $3,000 less than the student loan. Additionally, for households earning less than $309,900 per year (or $258,250 for single individuals) all of that interest is deductible.

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Take for example, a married couple consisting of a dentist and an accountant carrying $240,000 of student loan debt (average dental student loan debt in 2013 was $241,000), and a joint adjusted gross income of $300,000. That family would be squarely in the 33% tax bracket, meaning that the interest on a $100,000 home equity line of credit would provide them with a $4,000 tax deduction, or a reduction of their total tax liability of $1,320 per year ($4,000*33% tax bracket). Therefore, if that family is able, they should strongly consider “refinancing” existing loan debt through equity in their home. The savings would total over $4,000 per year ($2,800 in interest plus a reduced tax liability of $1,320).

Of course, this plan is not without pitfalls: the most glaring being that the couple has $100,000 of equity in their home. However, young owners may be surprised to learn how much equity that they have built in the last 5+ years, especially in urban areas. Additionally, married couples need to closely analyze their student debt situation. For those couples where only one borrowed and accumulated the student debt before marriage, careful consideration and planning must take place. Should that couple own the home jointly, the non-borrowing spouse would effectively be accepting personal responsibility for the debt. However, there may be estate planning techniques to avoid this pitfall.

Additionally, for those on income based repayment or “pay as you earn” plans, the lower monthly payment and potential loan forgiveness would be forfeited. Note, however, that in the long run, these repayment options can be extremely expensive as any amount forgiven by the government is taxable as income ($100,000 of loan forgiveness would likely trigger a tax due of $28,000-$33,000). This plan is best for those with stable careers and measured income growth. It is also likely inappropriate for those over the age of 60 (the fastest growing student-borrower population as a result of co-signer requirements).

There are some slight tangential advantages to stripping equity from the home to pay off student loan debt. Student loan debt is not dischargeable in bankruptcy, but home equity lines are. Certainly, one should not take advantage of this strategy with the plan to declare bankruptcy, as it is likely fraudulent and would not benefit the borrower. However, if unforeseen circumstances arise in the future, such as the incapacity or disability of a high-earner spouse, the debt may now be discharged where before it could not. Again, this cannot be the sole purpose for “refinancing” with home equity debt, but the added creditor protection is beneficial.

Ultimately, this is a niche plan best suited for young professionals with stable careers. There are other options out there for refinancing graduate student loans. Some private lenders have begun to identify high-quality credits, such as physicians, and are attracting borrowers looking to refinance at rates up to half of what the federal government is charging. The end result will be net negative for the taxpayer and average student borrower as the government’s portfolio will continue to be stripped of the higher quality credits, requiring the administration to charge higher rates to offset defaults. However, refinancing through such a lender would not provide for the same tax benefit as using home equity as only a fraction of the interest would be deductible, and would subject the borrower to income phase out restrictions. Further, the total debt load would be unchanged (mortgage plus student loan debt vs. mortgage plus home equity line), and a large portion would remain undischARGEABLE in bankruptcy.

Before engaging in any strategy, the borrower and their family should assess their current and future financial situation, their lending status, and their risk tolerance. This plan provides real benefits for the right borrowers, and vastly increases the return on educational investment. Any individual considering such a strategy should consult their financial advisor and tax professional.

UCC Financing Statements Are Not Impenetrable Shields

However, the Debtor was still operating its business as a going concern. Indeed, documents produced by the Debtor pursuant to the citation to discover assets revealed that its lender had made similar statements to other creditors, but at the same time had allowed the Debtor to continue operating instead of liquidating the Debtor’s assets to satisfy the loan. In fact, documents produced revealed that the lender had made additional loan advances to the Debtor after the date the Lender had supposedly declared the Debtor to be in default under the loan.

After submitting briefs to the Court detailing these facts, the Judge held that the Lender could not assert a higher priority under the UCC Financing Statement until it had declared the Debtor to be in default. The Judge determined that based upon the facts before him, most notably that the Lender had allowed the Debtor to continue operating and access to additional funding, that the Lender had not declared a default, or was actively assisting the Debtor in shielding its assets from creditors. The Judge went on to rule in my client’s favor, and ordered that the $80,000 receivable be turned over to my client to satisfy its judgment.

The moral of the story is that the simple existence of a UCC Financing Statement, or other security instrument, is not the end of the inquiry in collection proceedings. A diligent and savvy creditor may be able to obtain superior rights over a lender that has not declared a default and taken action to enforce its secured lien. If you have any questions regarding your collection issues, please give DiMonte & Lizak, LLC a call.

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How to Deal With A Preference

By: Ira P. Goldberg

In a bankruptcy proceeding, preference law is the means by which the debtor or a trustee, can recover a payment or other transfer which was made by the debtor within 90 days of the debtor’s bankruptcy filing or alternatively within one year in the case of a transfer to an insider. An insider is generally a person or entity that bears a close relationship to the debtor.

The preference law is designed to treat all creditors equally. The main purpose of the law is to clawback transfers and eventually make them available for redistribution among the creditors of the estate. This purpose, however, does not always work perfectly and certainly does not provide much solace to a creditor who is being sued for such a recovery. After all, the creditor was simply paid a debt owed to it for services or products it actually provided. The creditor may also still have an unpaid balance with the debtor. Therefore being sued for a preference, from the creditor’s viewpoint, is simply rubbing salt in the wounds.

If you operate a business you may run into a preference payment situation. DiMonte & Lizak is well versed in this area of law and may assist in softening the blow or minimizing the risk when you suspect that someone you are dealing with may be heading towards bankruptcy. This article is only intended to give you a primer on how to deal with such situations.

The basic elements of a preference are as follows:

1) A transfer of an interest of the debtor in property;
2) To or for the benefit of a creditor;
3) For or on account of an antecedent debt owed by the debtor before such transfer was made;
4) Made while the debtor was insolvent;
5) Made on or within 90 days of the date the bankruptcy was filed (or within 1 year if the creditor was an insider); and
6) That enables the creditor to receive more than it would have received in a Chapter 7 liquidation.

There are various defenses to a preference. The most common are as follows:

1) The parties intended the transaction to be a contemporaneous exchange for new value and it actually was one;
2) The ordinary course of business, generally either based upon the parties history of dealings or of the norms of the industry;
3) Perfection of a lien for which a relevant statute provides for relation back if compliance is within a statutorily specified time period;
4) Subsequent new value. The delivery of goods or services after the alleged preference; and
5) Solvency. Insolvency, however, is presumed within 90 days of the filing.

There are also various business practices, when dealing with a person or entity that is likely to wind up in a bankruptcy, that may insulate you or provide some protection. One simple method is to receive prepayment or simultaneous payment (Cash on Delivery). Prepayment results in the transfer not being made on the account of an antecedent debt. You must take care to document/evidence that the parties agree to, intend to, and have actually consummated the desired business practice. Generally, under the preference law, unless otherwise specified by the parties (best practice in writing), payments are applied to the oldest invoices. Therefore if you did not document a prepayment or contemporaneous payment, as being the intent between both you and the debtor, the payment will most likely be allocated to the earliest invoice, which very well might result in preference exposure. The adherence to a prior consistent course of conduct between the parties may also provide some protection. For instance, if there is a history under which the debtor always paid your business within 30 days of invoice, and assuming invoices are promptly issued and not backdated, the adherence to that practice will strengthen an ordinary course defense. A separate defense would be adherence to the ordinary terms of payment of the industry that is involved.

Regardless of the forgoing it almost always is best to accept payment without concern of a clawback. The person or entity may never file for bankruptcy or the filing, as relevant to you, could be outside the clawback period. Preferences can also be settled. We can assist you if such litigation is threatened or filed.

In the event you suspect someone who you are dealing with is unfortunately heading towards a potential bankruptcy, it is prudent to contact a lawyer specializing in bankruptcy law. At DiMonte & Lizak we have several attorneys with that specialization.

DiMonte & Lizak is Proud to Announce the Hiring of Jeffery Ramirez

Jeff joined Di Monte & Lizak’s transactional department in June of 2015. Jeff devotes his practice to real estate and business transactions, estate planning and taxation. Jeff earned his B.S with honors from DePaul University in Accounting with a minor in Economics in 2011. Jeff earned his juris doctorate degree from DePaul University College of Law in 2014. He lives in Des Plaines with his wife and daughter.
An experienced, multi-practice law firm working as a team to provide practical counsel and quality services.

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