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Living Trusts, Wills, and Your Estate Plan

Many people are hearing more about using a **revocable living trust** in place of a **will**. While it is true that a properly managed revocable living trust provides unique benefits, it does not completely replace a will. In determining whether this type of trust is right for you, it helps to understand the major purpose, benefits, and trade-offs of this estate planning tool.

A revocable living trust is created during your lifetime, and you can alter it in any way and at any time. One of its key features is that it allows you to retain control of the management and distribution of your assets.

The Probate Issue

Many people establish a revocable living trust to avoid **probate**, which is the legal process of settling your estate. Assets distributed from a trust upon your death *do* avoid probate. However, the probate process itself is not as burdensome for many estates as in the past. Many states have adopted the Uniform Probate Code, which greatly simplifies the process for many small- to medium-sized estates.

But, even with improvements in the probate process, the probated assets in your estate still become a matter of public record, which raises important privacy concerns. Avoiding probate may also make sense if you own properties outside your state of domicile, which means your estate would be subject to multiple probate proceedings.

Once you set up a trust, you must make sure to transfer assets into it. Failing to do so will subject your assets to probate. Simply signing a trust document *without* retitling assets renders your living trust useless.

If I “Fund” a Trust, Do I Still Need a Will?

The short answer is yes. Generally, a revocable living trust cannot entirely replace the need for a will. There are some assets you may not wish to place in a trust. For example, it may be impractical to transfer tangible personal property such as automobiles, furniture, and jewelry to a trust. Consequently, some of your assets will remain outside your trust, making a will necessary to specify your intended beneficiaries. If you have minor children, a will can also be used to designate a **guardian** for them.

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Taking Annual Gifts to Another Level

If you're like most individuals, you've probably worked a lifetime to build your own American dream—an adequate nest egg, a comfortable home, and an array of other assets. Then, at one point or another, you may realize that your finances could create unfavorable estate tax consequences. So, you take care of the compulsory legal documents—wills, trusts, etc.—and learn along the way that giving away assets may help reduce the size of your taxable estate. Even though many individuals make occasional gifts to their children or other family members, few actually take advantage of the benefits offered through a *regular gifting program*.

Gifts Made Simple

Current tax laws allow you to give away \$13,000 (\$26,000 if married) in 2009 to as many people as you wish *without* incurring any gift taxes. This \$13,000 **annual gift tax exclusion** can be an effective means for gradually passing wealth to future generations. In fact, systematically making such a gift can yield a rather sizable long-term benefit.

Consider this example. Suppose 60-year-old Joseph starts a gifting program for his newborn grandson, Alex. Each year, Joseph makes a gift of \$13,000. After 25 years, Alex will have accumulated \$325,000, assuming 0% growth. In addition, suppose Joseph's wife Helen, also age 60, chooses to make a \$13,000 gift to Alex as well, bringing the total annual gift to \$26,000. In this case, Alex will have accumulated \$650,000 in 25 years (assuming 0% growth). With this win-win scenario, Joseph and Helen help Alex accrue a nest egg, while, at the same time, lowering the value of their estate. This strategy will help Joseph and Helen minimize their estate tax liabilities.

One Step Beyond

Using the annual gift tax exclusion to fund a **life insurance** policy creates the potential to leverage gifts into a substantial death benefit. For instance, take another look at Joseph. Suppose Joseph (the donor) sets up an **irrevocable life insurance trust (ILIT)** for the benefit of Alex. The ILIT then purchases life insurance on Joseph.

Upon Joseph's death, the life insurance death benefit proceeds are payable to the ILIT. Since the policy is owned by and payable to the ILIT, there are no **transfer tax** consequences to Joseph's estate.

Life insurance may provide an ideal mechanism for leveraging annual gifts. In the short term, it offers an immediate death benefit that generally outweighs the total premium outlay (gifts). Over the long term, life insurance offers a unique opportunity to potentially leverage annual gifts into a significant benefit for selected beneficiaries. This can be achieved by taking advantage of the tax-deferred buildup of policy values, which in some cases may indirectly increase the life insurance policy's death benefit over time.

The use of a regular gifting program may be advantageous to individuals seeking to gradually reduce the size of their estates. In addition, it affords these individuals the opportunity to pass wealth to children, family members, and others with reduced tax consequences. ■

Work-Related Educational Expenses: Are They Deductible?

An increasing number of individuals are going back to school to improve their technical or professional skills, qualify for advancement, bring home higher paychecks, or just improve their quality of life. We all know education costs money and tuition is expensive. But you may be able to offset some of the expense by claiming a deduction for your work-

related educational expenses on your tax return. Let's take a closer look at the rules.

First, in order to deduct work-related educational expenses, you must *itemize* deductions on your tax return, rather than take the standard deduction. In general, a taxpayer will itemize deductions when the total of qualified deductible expenses exceeds

the standard deduction or if the taxpayer does not qualify for the standard deduction because of income limitations. For tax year 2009, the standard deduction is \$5,700 for single filers and \$11,400 for joint filers.

Second, work-related educational expenses are considered "miscellaneous" expenses when itemizing and are therefore subject to a 2% floor.

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Family Employees Bring Home Tax Benefits

If you are the owner of a small business, employing your children may help reduce both your family's aggregate income subject to taxation and the effective rate at which that income is taxed. Whether you are running your business as a corporation, partnership, or sole proprietorship, putting a family member on your payroll makes that person's income—and the costs associated with his or her employee benefits—deductible business expenses.

As a result, the gross income of your business is lowered. While the total family income may remain essentially the same, the income paid to the family member (assuming he or she is not a spouse) is generally taxed at a lower rate. In addition, certain employee benefits are not taxable to the family member. In effect, the family's overall tax liability is lowered.

Good News: Now and Later

Suppose that you have a teenage daughter, Susan, who has good computer skills. If you directly pay Susan the going rate for maintaining your database, and keep a record of her hours and the work performed, her salary is tax deductible as a business expense. As long as her wages are less than the standard deduction (\$5,700 in 2009), her income will be nontaxable. Income above that amount will be taxed at Susan's presumably lower tax rate.

On the other hand, imagine that your daughter Susan is still an infant. If Jane, your spouse, works in your business, the cost of childcare while she works will be lessened through the allowable childcare tax credit for such expenses.

Looking forward 20 years, having your wife Jane on the payroll could help out with retirement planning. Your company's pension plan, or defined benefit plan—which qualifies under the Employee Retirement Income Security Act (ERISA, amended in 1974)—allows Jane to receive an annual minimum distribution of \$10,000, regardless of whether her annual salary ever got that high. Most importantly, during Jane's 20 years of service, your business was able to deduct contributions to the plan on her behalf from gross income.

Perhaps your business offers a qualified retirement plan, such as a 401(k) plan. If so, the contributions made by your business to Jane's account, up to a certain amount, also qualify as a tax-deductible business expense.

IRAs Are Family-Friendly

If your business does not offer a qualified retirement plan, or if family members like Jane and Susan do not participate in such a plan, then an Individual Retirement Account (IRA)—available only to employed individuals or their spouses—is an option. IRA contributions—limited to \$5,000 in 2009 or \$6,000 for those age 50 and older—are tax deductible, subject to certain income limits for the employee (but not the business), and allow for tax deferral



on earnings until distributions are taken. Distributions taken before the age of 59½ may be subject to a 10% Federal income tax penalty, as well as ordinary income taxes. Certain exceptions may apply.

Other Benefits

As employees, Jane and Susan are eligible for other employee benefits your company may elect to provide, such as **accident and health coverage, group term life insurance, and tuition assistance**. The costs of these benefits, assuming they are reasonable, are also deductible business expenses.

Keep in mind that employing family members means they must actually work in the business for compensation that is reasonable for the type of work they are performing. Also, be aware that the tax status of any retirement account or plan vehicle (and there are many types) is strictly governed by statutes and regulations that cover both employer and employee. Nonetheless, putting family members on the payroll can often bring home financial and tax benefits. For more information, consult your tax professional. ■

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This means that you can only deduct the amount of miscellaneous expenses that exceed 2% of your gross income.

To be deductible, your expenses must be for education that maintains or improves your job performance, serves the purpose of your employer, or is required by your employer or by law to keep your salary, status, or job. The education must be linked with “carrying on a trade or business” in which you are already active, and it must be closely related to your current job skills. For instance, an accountant can write off courses that explain new tax rules, and a professional pianist can write off music lessons.

Expenses do not qualify if the education is needed to meet the minimum requirements of your present trade or business, or if it is part of a program of study that will qualify you for a new trade or business. Educational expenses that enable you to qualify for a promotion may be allowed. Generally, if an individual changes *duties*, it is not a *career* change, as long as he or she remains in the same line of work.

Work-related educational expenses that are deductible include those for tuition, books, supplies, lab fees, and similar items; certain transportation and travel; and other educational services, such as the cost of research and typing when part of

an educational program. You cannot deduct personal or capital expenses, such as the dollar value of vacation time or annual leave taken to attend classes. This is a personal expense. Also, you cannot claim any expenses that qualify for reimbursement from your employer, even if you do not receive the reimbursement.

Enhancing your job skills is worthwhile, regardless of whether you get a tax break. However, your work-related educational expenses may qualify, so be sure to keep accurate records of all deductions to substantiate your expenses. For more information, consult your tax professional. ■

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Also, some assets may require special considerations. For example, retirement plan accounts (**Individual Retirement Accounts (IRAs)**, **401(k)s**, **profit-sharing plans**, and **Keoghs**, to name a few) cannot be retitled to a living trust, although you could change the beneficiary designation to the trust. However, naming someone other than a spouse as beneficiary of a qualified retirement plan may require spousal consent, since in many states, spouses now have

rights to retirement plan benefits. In addition, naming your trust, rather than your spouse, as the beneficiary of your qualified plan may have income tax consequences when you die.

Advanced Issues

Revocable living trusts are complex legal documents. In addition to the advantages mentioned, they offer other benefits, as well. For instance, under the right circumstances, a properly funded living trust can help

reduce estate taxes. The bottom line is that qualified legal expertise is a must in order to help ensure proper planning. Your legal professional can help you examine all variables affecting your property—the *type* of assets (e.g., real estate, life insurance, bank accounts, savings, business interests, and personal property), *where* they are located, and *how* they are titled—to determine if a revocable living trust can benefit your short- and long-term estate planning goals. ■

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