

Patrick J. McNamara, MSFS
E-mail: pmcnamara@finconcepts.com

Financial Concepts, Inc.

A Member Firm of M FINANCIAL GROUP
617 Detroit Street, Suite 120
Ann Arbor, MI 48104-1112

Tel: (734) 214-9770 • Fax: (734) 214-9771

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Like-Kind Exchanges— Still a Viable Tax Shelter

Are you holding onto appreciated property or real estate because you fear a large capital gains tax bill upon the property's disposal? Don't let fear paralyze you. You can circumvent this problem with a like-kind exchange.

The IRS allows you to defer the gain on property as long as it's exchanged for replacement property of a like kind—that is, property of the same nature or character.

How Does It Work?

Most exchanges of real property qualify as like-kind exchanges, no matter what their use. For example, you could exchange farmland for an apartment building of equal or greater value without recognizing any gain at that time (providing neither property qualifies as your residence). Your basis in the new property is reduced by the amount of deferred gain, as shown in the example.

Example

George purchased his first investment property, a parcel of land, for \$50,000 in 1997. Today, the land is worth \$75,000. George wishes to dispose of it and buy a new piece of land worth \$100,000. If George sells the land and then pays that \$75,000 plus an additional \$25,000 for the new land, here's what his tax situation would look like:

Sale and Purchase	
Sale price of farmland	\$ 75,000
Less basis in land	<u>(50,000)</u>
Gain on sale of farmland	25,000
Tax rate	× 20%
Current year tax liability	<u>\$ 5,000</u>
Basis of newly acquired land	<u>\$ 100,000</u>

What if George trades his old land and \$25,000 in cash in exchange for the new parcel of land? That scenario would result in the following:

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	Like-Kind Exchange
Sale price of farmland	\$ 75,000
Less basis in land	<u>(50,000)</u>
Gain on sale of farmland	25,000
Gain deferred	<u>(25,000)</u>
Current year recognized gain	<u>\$ 0</u>
Cost of acquired property	\$ 100,000
Less: deferred gain	<u>(25,000)</u>
Basis of newly acquired land	<u>\$ 75,000</u>

Using a like-kind exchange would allow George to keep an additional \$5,000 in his pocket. If George were to receive property of a like kind plus cash and/or other property in an exchange, he would have to recognize the gain, but only up to the value of the other property received. Any remaining gain would be considered as generated by the like-kind exchange.

Creative Transactions

Referring to the example, what if the owner of the land didn't want

of the new land to George.

Even though this is a three-party transaction, it would still qualify as a like-kind exchange if performed properly. However, there are special rules as to who qualifies as a facilitator, and timing is critical as tax advantages may be lost if not executed within established time constraints. As with all complex tax matters, professional guidance is important.

New Rules, New Benefits

Like-kind exchanges provide even more benefits now because of

George's land in exchange? If George had a buyer for the farmland, he could hire someone to perform the sale and purchase. George would first transfer title of the farmland plus the cash to the facilitator. The facilitator would then: 1) sell the farmland, 2) purchase the new land, and 3) transfer title

changes in the depreciation rules. Previously, depreciation on the entire amount of basis in the new property would start over. Now, for exchanges occurring after January 3, 2000, the portion of the basis in the new property attributable to the remaining basis in the old property will continue to be depreciated as if the property was never disposed of. This will often result in faster depreciation than under the old rules.

Watch Your Step

Like-kind exchanges can also backfire. While they allow you to defer gain on an exchange, you must also defer any loss on the exchange. Therefore, it may be wise to sell properties where the fair market value is less than its undepreciated basis, such as in the case of an automobile trade-in. Things can also be tricky if debt is being transferred. You don't want to be surprised by gain. The like-kind exchange is a powerful tax-planning tool, but it must be executed properly. Consult your qualified tax professional for specific guidance. ■

Your Financial Affairs— What Your Children Should Know

many parents may find it uncomfortable, or may believe it is unnecessary, to inform their children about their personal matters. Yet, preparing your family helps everyone feel better about your financial and healthcare wishes, and it can ease the decision-making process in many important areas.

As you grow older, informing your children of financial, estate, and

medical arrangements that could affect the entire family helps everyone prepare and plan for the future. This knowledge need not include exact facts and figures; however, the following information should be made available to, and understood by, your grown children:

- **Life Insurance.** Life insurance is typically purchased to provide cash to help cover mort-

gages, liabilities, expenses, estate taxes, and lost income. Knowledge of the existence and whereabouts of life insurance policies can be of critical importance to children when settling their parents' financial affairs. A policy locked in a safe deposit box may not be found in a timely manner, if ever.

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- **Other Insurance.** Adult children should be aware of any other insurance policies that you may have—including health, disability income, and long-term care insurance. If you are age 65 or older, they should also have a basic understanding of **Medicare** coverage and be aware of any health insurance policies that go beyond coverage provided by Medicare. Older adults can greatly benefit when their children understand and follow appropriate procedures, as well as submit any necessary forms in a timely manner.
- **Wills.** It is important to prepare a will in order to avoid leaving the disposition of your estate up to your particular state and its laws. To help ensure assets are distributed according to your wishes, both you and your spouse should prepare wills, review them regularly, and make necessary updates as circumstances warrant.

Although the exact contents may be kept private, the existence and location of wills should be disclosed to all family members. Wills should not be kept in bank safe deposit boxes, which may be sealed at death. The original will may be left with your attorney for safekeeping.

- **Trusts.** Although wills accomplish many estate-related tasks, trusts may help protect your estate from unnecessary taxation or mismanagement by individuals who might lack the prudence to handle matters appropriately. Trust documents should be kept with wills for ease of access. You should

discuss pertinent terms with those who will be involved. As children reach adulthood, it is common for parents to select a responsible son or daughter to act as a **trustee** in the event of the parents' deaths.

- **Living Will.** This document specifies your preferences regarding the administering or withholding of life-sustaining medical treatment. Under many state statutes, a patient must be considered “terminal,” “permanently unconscious,” or in a “persistent vegetative state” before life support can be withdrawn. Copies of living wills should be made available to anyone who would be involved with the care of you or your spouse, and the originals should be kept in a safe, readily accessible storage place.
- **Health Care Proxy.** This legal instrument allows you to appoint a person to act as an agent on your behalf to make medical decisions if you should become incapacitated. A copy of the health care proxy should be filed with your primary doctor and your hospital, if possible. The individual appointed as your agent should also retain a copy, and you both should carry a copy with you at all times if you anticipate that medical care may be required.
- **Durable Power of Attorney.** With a durable power of attorney, an individual or financial institution may act as an agent to oversee your legal and financial affairs in the event of incapacity. Grown children need to be informed of the steps that have

been taken to ensure the competent direction of your affairs, should the need arise. However, their actual *involvement* in your affairs may be limited, according to your desires. A power of attorney automatically terminates upon the death of the principal.

- **Assets and Debts.** It can be beneficial for your children to know that a list of your assets and debts exists, without necessarily seeing the list itself. An asset list, developed and updated regularly, may include information on your bank accounts, real estate holdings, pension holdings, annuities, business agreements, brokerage accounts, boats, cars, works of art, collectibles, other valuables, and insurance policies. A debt list should include information on your current mortgages, consumer indebtedness, personal loans, and business obligations. Both lists should identify *where* paperwork and associated files for each item can be found.

Planning for a worst-case scenario may help your loved ones through an unforeseen tragedy. At first glance, preparing these lists and the associated documentation may appear burdensome. However, once completed, both parents and children can enjoy a sense of confidence that the thoughtful planning they have implemented will ultimately be properly fulfilled. ■



Disability Income Insurance— Protecting Your Most Valuable Asset

have you ever asked yourself how you would manage if you were to suffer a severe accident or illness that left you unable to work? How long could you maintain your quality of life, pay your bills, and cover your daily expenses? The likelihood of such an event may be greater than you think. According to the Insurance Information Institute (III, 2005), an individual between the ages of 40 and 65 has a *greater* chance of missing at least three months of work due to an accident or illness than of suffering an untimely death. To compound the problem, the recovery period may run as high as a lengthy two and a half years.

To be prepared for such a situation, it is important to *plan ahead*. A smart approach to help protect you is to purchase an **individual disability income insurance** policy. However, there are a few considerations to keep in mind when choosing this coverage:

- **Definition of Disability.** Carefully review your policy's definition of disability. Some policies may provide coverage if you are unable to work in the occupation in which you were employed or for which you were trained, or if you can no longer earn as much as you once did in that field. In contrast, other policies may offer coverage only if you

are unable to work in *any* occupation. This distinction can make a big difference if you become disabled.

- **Residual Benefits or Partial Disability Coverage.** Under certain specified circumstances, if you become disabled and are only able to earn a *portion* of your previous income, residual benefits or partial disability coverage pays a portion of your benefits.
- **Guaranteed Renewable.** With this feature, the insurer cannot refuse to renew your policy or change any terms, except for premium cost, as long as you continue to pay your premiums on time.
- **Guaranteed Insurability.** This provision allows you to increase your monthly benefit, even if you experience health changes that would otherwise prevent you from obtaining additional disability coverage.
- **Cost-of-Living Adjustment (COLA).** This feature helps protect your benefits against the effects of inflation during a long-term disability.

The Outlook without Protection

If you don't have a disability income policy, there are alternatives, although they all have shortcomings.

For instance, you could self-insure. However, even if you save 10% of your salary each year, one year of disability could easily wipe out many years of savings. Or, perhaps your employer provides disability income insurance. Unfortunately, **employer-sponsored plans** are often limited in scope and duration, and coverage is not portable upon termination of employment (except in certain executive disability policies). **Workers compensation** may be an option in some cases; however, it only covers injuries suffered on the job. Eligibility and benefits vary by state.

To qualify for **Social Security** disability benefits, you must be severely disabled, and even then, you will have to wait at least six months for payments to begin. Social Security disability was not intended to be an individual's sole source of disability income; thus benefits are often less than what you might need to cover your regular living expenses.

A debilitating illness or injury that cuts off or reduces your primary source of income can be a financially devastating experience—one from which it can be difficult to recover. Disability income insurance can play an important role in your overall financial program. ■



The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.