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in this issue:

Offset the Effects of
Inherited Wealth
with Incentives

Understanding Life
Insurance Beneficiary
Designations

New Tax Act Extends Savings for Investors

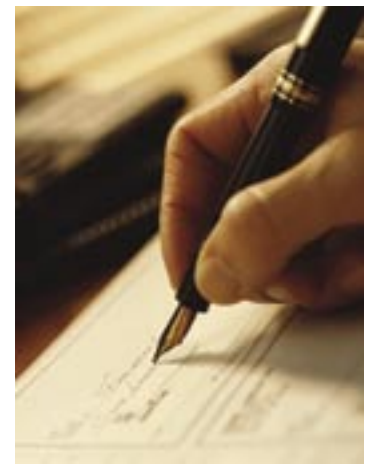
a \$70 billion tax cut package, the Tax Increase Prevention and Reconciliation Act (TIPRA), became law on May 17, 2006. At the center of this legislation is the extension of lower long-term capital gains and dividend rates through 2010. In addition, this measure provides AMT relief. To balance these tax breaks with revenue-raising provisions, this bill applies the “kiddie tax” to children under age 18 instead of age 14, effective immediately, and permits higher-income taxpayers to convert traditional IRAs to Roth IRAs, beginning in 2010.

Good News for Investors

TIPRA extends the 15% tax rates on long-term capital gains and qualified dividends through 2010. Put in place by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), these reduced rates had been due to expire at the end of 2008. Taxpayers in the 10% and 15% income tax brackets pay 5% through 2007, and then zero tax on long-term gains from 2008 through 2010. Prior to the enactment of JGTRRA, the top rate for long-term capital gains was 20%, while dividends were taxed as ordinary income at a maximum rate of 35%.

AMT Relief

This legislation also raises the 2006 AMT exemption amounts to \$62,550 for married couples filing jointly and \$42,500 for single filers. If no congressional action had been taken, the exemptions for the 2006 tax year would have fallen to \$45,000 for joint filers and \$33,750 for individuals. Under the new law, taxpayers may use all nonrefundable personal credits to offset AMT liability.



continued on page four

Offset the Effects of Inherited Wealth with Incentives

For many affluent individuals, estate planning extends well beyond mere tax planning and involves very personal decisions regarding the distribution of future wealth. In more traditional estate plans, the **spendthrift trust** is used as a mechanism for distributing trust income, while limiting immediate access to trust principal.

A spendthrift trust can help provide financial security and stability for minor children, as well as protect adult heirs from some creditors and personal failures in judgment. However, such trusts may provide heirs with little incentive to expand their own professional, academic, or philanthropic horizons. Thus, affluent individuals who are particularly sensitive to the potential ramifications of “handing over” considerable wealth to heirs may find comfort in adopting an *incentive-based* estate plan.

One of the cornerstones of an incentive-based estate plan is the **family incentive trust (FIT)**. Like typical trusts associated with estate planning, a FIT serves as an outline that guides trustees in the implementation of an affluent grantor’s expectations regarding the future uses of his or her estate. Similarly, a FIT can help ensure proper care and financial support if an heir falls on hard times or has special needs. However, a FIT is somewhat unique in that the *general* distribution of trust income is rooted in a series of predetermined “incentives.”

What Is “The Incentive”?

The incentives outlined in a FIT are virtually up to the imagination of the grantor. Each incentive provides the grantor with the ability to

encourage specific, future behavior. For instance, the trust could have provisions that pay each heir \$10,000 upon the receipt of a bachelor’s



degree, \$25,000 for a master’s degree, and \$50,000 for a doctorate. A FIT can also be an ideal mechanism to reward family members who pursue and/or distinguish themselves in a favored career path of the grantor’s choosing, such as the family business, music, the arts, research, or teaching. Or, a FIT can reward younger heirs for academic success or community involvement. In addition, the trust could match certain levels of income for heirs who are younger than a specified age (e.g., 35).

A FIT also can be an excellent education-funding vehicle. Unlike a custodial account, which generally becomes the property of the child once he or she attains the age of 18, a FIT can dictate that some trust assets be utilized to help fund education costs. Thus, the trust, rather than a young, inexperienced adult, can maintain control of monies earmarked for education.

Another interesting use of a FIT is one that allows trust principal to act as a “family bank.” The FIT can offer low interest rate loans for start-up business ventures or the purchase

of a primary residence. A lending process similar to that of a traditional lending institution can be required to help ensure minimal risk to the trust.

Philanthropy creates another intriguing possibility for an incentive-based estate plan. Certainly, many affluent individuals consider philanthropic pursuits very important endeavors. A FIT can be used to match the charitable contributions of a beneficiary. If so desired, the FIT’s matching contribution can be arranged as a distribution to the beneficiary, which is then contributed to the charity. Thus, the beneficiary can reap the benefits of a charitable deduction on both his or her own contribution, as well as the FIT’s matching contribution. Similarly, any remaining trust income that has not been distributed through incentives may make for an ideal contribution to a family foundation or charity. Such contributions also can be arranged so they are made on behalf of trust beneficiaries.

Instilling Family Culture

Sometimes, the effects of inherited wealth can have a less than positive impact on the motivation of heirs. For instance, when some heirs receive a substantial inheritance, they may be content with a lifestyle of leisure. Thus, the reasoning behind incentive-based estate planning is fairly straightforward. Assets and income are distributed to assist heirs who are realizing career or academic goals, and/or whose actions are consistent with the expectations of an affluent grantor. By adopting some of the principles of incentive-based estate planning, the affluent grantor can create an environment that promotes a family culture of excellence and productivity for generations to come. ■

Understanding Life Insurance Beneficiary Designations

In the language of life insurance, a **beneficiary** is the recipient of the proceeds of a policy when the named insured dies. The owner of a life insurance policy has a great deal of flexibility in naming beneficiaries and can generally name anyone he or she chooses. When making beneficiary decisions, it is important to ensure that the wishes of the policyowner are fulfilled and that legal complications are avoided.

Types of Beneficiaries

Beneficiaries are typically categorized as either **primary** or **contingent**. A **primary** beneficiary is entitled to the proceeds of the policy upon the death of the insured, but such rights expire if he or she dies before the insured. A **contingent** (or secondary) beneficiary is entitled to the policy proceeds if the primary beneficiary has predeceased the insured. One fairly common arrangement might stipulate that, if a primary beneficiary dies before collecting the entire proceeds of the policy, then the remaining amount will be payable to the contingent beneficiary. It is often desirable to have several levels of contingent beneficiaries.

A beneficiary can be either **specific** (a person identified by name and relationship) or a **class designation** (a group of individuals such as the “children of the insured”). While the naming of specific beneficiaries is usually clear-cut, unintended complications can arise when designating *classes* of beneficiaries.

For example, if you plan to name your children as beneficiaries, you will need to clarify if you intend to include adopted children or children

by a former spouse. If your children are minors, it is also important to determine if the insurance company will in fact pay the proceeds to a minor beneficiary. Generally, insurers insist on paying proceeds to a legal guardian rather than to a minor.

Consider the following hypothetical situation in which the policyowner’s intentions appear straightforward, but could become complicated. Harriet, who is seventy years old, has planned for the proceeds of her life insurance policy to be paid to her children (Sam, Carole, and Jill) or her grandchildren. Now, suppose Sam and Carole die before their mother. Sam leaves four children and Carole has no children. How will the proceeds of



the policy be distributed when Harriet eventually dies?

Methods of Distribution

Per stirpes and **per capita** are terms that describe methods of distributing property to family members and heirs. *Per stirpes* means “branches of the family,” and *per capita* means “by heads.” In the example above, under a *per stirpes* distribution, Jill (one branch) would receive one-half

of the proceeds and Sam’s surviving children (the other branch) would divide the remaining half among themselves. Under a *per capita* distribution, Sam’s four children, along with Jill, would *each* receive one-fifth of the proceeds. Remember, there might be complications if any of Sam’s children are still minors when Harriet dies and legal guardians have not been appointed.

Revocable vs. Irrevocable

There are also different consequences according to whether beneficiary designations are revocable or irrevocable.

If a beneficiary designation is **revocable**, the policyowner reserves the right to change the beneficiary. A person designated as a revocable beneficiary has only an “expectation” of benefits, since the owner of the policy can exercise any of the policy rights without the consent of the revocable beneficiary.

On the other hand, an **irrevocable** beneficiary designation cannot be changed without the consent of that beneficiary. While this arrangement is sometimes desirable for estate planning purposes, the legal status of an irrevocable beneficiary is uncertain. Some may regard an irrevocable beneficiary as a “co-owner” of the policy; therefore, the beneficiary’s consent is needed to exercise any policy rights. At the other extreme, others may contend

new tax act extends savings for investors

continued from page one

Expanding the Kiddie Tax

The law also raises the age limit for the “kiddie tax” from 14 to 18 years of age. These new rules take effect in 2006. Unearned income, such as dividends and interest, exceeding \$1,700 for children under age 18 will now be taxed at the parents’ top rates, unless the child is married and files a joint return. Prior law applied the kiddie tax to children under age 14. This allowed children 14 and older to pay taxes on their investment income at rates most likely lower than their parents’ top rates. An exception applies to distributions from qualified special needs trusts.

Roth IRA Conversions

TIPRA also eliminates, starting in 2010, the current \$100,000 adjusted

gross income (AGI) ceiling on converting traditional IRAs to Roth IRAs. Funded with after-tax dollars, Roth IRAs offer tax-free earnings and tax-



free distributions, provided you have reached age 59½ and have owned the account for five years when you make

withdrawals. Unlike traditional IRAs, Roth IRAs have no minimum distribution requirements at age 70½. Conversions are treated as distributions; therefore, you will be taxed on the full amount, but not penalized for early withdrawal.

This legislation also extends enhanced Section 179 expensing through 2009, which benefits business owners looking to write off qualified equipment purchases. Given the temporary nature of this latest reform and the possibility of further changes on the horizon, it is important to regularly review your tax and financial strategies. For more information and specific guidance, consult your tax professional. ■

understanding life insurance beneficiary designations

continued from page three

that an irrevocable beneficiary’s consent is needed only for exercising a change of beneficiary.

The latter position can create the somewhat puzzling effect of having the beneficiary’s rights compromised if the policyowner exercises other rights, such as surrendering the policy or permitting it to lapse. Due to the vague legal status of an irrevocable designation, it is usually preferable to use revocable beneficiary designations.

A further complication can arise when one’s estate is named as a beneficiary of a life insurance policy. The policy proceeds may be tied up in the probate process or reduced by the claims of creditors.

The distribution desired by a policyowner must be clearly set forth in the beneficiary designation. A change in family circumstances after a policy is initially written, such as a divorce, could leave you with unintended ben-

eficiaries, so it is important to review your insurance policies whenever such changes occur. If you are unsure about your beneficiary designations, check your policies, and take the steps necessary to make any appropriate changes. Your family will appreciate your thoughtfulness. ■

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.