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Business Ownership: What Structure Is Best?

Small business owners have unique financial, tax, and liability concerns, which should be addressed by their form of business ownership. In particular, how you structure your business will determine your tax treatment and your liability risk. As your company grows or ownership changes, reassessing your initial choices is wise. This article explores the characteristics of five basic business entities: **sole proprietorships**, **partnerships**, **C corporations**, **S corporations**, and **limited liability companies (LLCs)**.

Sole Proprietorships

The vast majority of small businesses start out as sole proprietorships, but owners should be aware of the personal liability risk. One person owns a sole proprietorship and typically runs the business. Sole proprietors own all assets and profits, and income is subject to individual income tax, as well as self-employment tax. The sole proprietor assumes personal liability for all aspects of the business, including debt and legal action taken against the business.

Partnerships

Two or more people own a partnership, and there are several types, including general partnerships, limited partnerships, family limited partnerships, and limited liability partnerships. A legal agreement generally specifies how profits will be shared, delineates the management responsibilities, and provides guidance for resolving disputes and dissolving the partnership. General partners face unlimited personal liability, whereas limited partners assume liability no greater than the capital they contribute.

Tax treatment is similar to that of sole proprietorships. The partnership entity is not taxed; however, partners are subject to income tax on their compensation, plus self-employment tax, if applicable. Losses also pass through to partners, and restrictions on deductibility apply. Because of this “pass-through” taxation, partnerships avoid the double taxation that corporations may face.

C Corporations

Shareholders own a corporation, which is considered by law to be a unique entity separate from those who own and run it. The corporation pays corporate taxes, and the shareholders pay tax on the income they receive as

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Valuation “Insures” Protection

Television shows featuring auctions and appraisal fairs have ushered the art of appraising into the limelight with fascinating stories—an ancient artifact unknowingly passed down from generation to generation, a rare trinket picked up at a yard sale, or an historic relic found tucked away in the corner of the attic. While appraisals occasionally lead to surprising discoveries, they more often play a key role in developing financial strategies.

If you know you own expensive items, such as jewelry, antiques, or artwork, consider having your valuables appraised for insurance, estate planning, and tax purposes. An **appraisal** is an expert valuation of property. Appraisers, practitioners of valuation, are professionals trained to provide more than a guess at an object's worth; they assess value based on formal methodology and comply with standards and codes of conduct generally practiced in the field. An appraisal can help you make informed financial decisions, as well as provide you with professionally prepared

documentation you need to validate your property's worth to a third party, such as the Internal Revenue Service (IRS) or an insurer.

The “Value” of an Appraisal

Appraisals can help you secure appropriate insurance coverage, preserve your estate, and develop tax strategies. You may not be able to put a price on your possessions, but an independent appraiser can. Knowing the worth of your valuables can help you tailor your financial strategies to your needs.

For insurance purposes, valuation can help you choose appropriate coverage for your property, as well as receive the reimbursement you are entitled to in the event you need to file a claim. Most **homeowners policies** generally exclude expensive items, such as furs, jewelry, and silver, from basic coverage, but they do offer protection at additional cost. To boost coverage, consider a “scheduled personal property endorsement,” a list

that amends the basic homeowners policy with bills of sale or appraisals dated within the past two years for such expensive property. Insurers also sell “extra articles coverage” as part of the homeowner's package. Under this coverage, homeowners pay an extra premium and accept adjusted deductibles to increase the per-item benefits without the need for appraisals or bills of sale. Choosing the best approach, either extra articles coverage or scheduling items separately, depends on the possessions involved and the premium formulas of the insurance company.

Certain life events, such as death and divorce, often call for the equitable distribution of property. When a person dies, all possessions of the deceased play a part in the cumulative value of his or her estate, so having appraisals for the items of value will assist in the division of the estate, as well as the determination of estate tax. Oftentimes, **probate** may require that an entire estate be inventoried and valued. In the event of a divorce, appraisals often assist with the division

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Borrowing from Your 401(k) Plan

A majority of companies that offer **401(k) plans** allow participants to take loans from a portion of their balance under certain conditions. The upside to such a loan is that when repaying it, the participant is actually paying himself or herself the interest. But, if you're considering such a loan, beware.

Indiscriminately accessing your account could void its tax-deferred status and result in penalties.



If the loan isn't repaid within a certain period (usually five years) and in accordance with certain rules, the

Internal Revenue Service (IRS) may view the outstanding balance as a withdrawal and assess both taxes and a penalty. If the employee voluntarily terminates employment, the company may demand full repayment of the loan. In that case, the

401(k) plan would be rolled over or broken up, and the borrower may owe taxes on the loan balance and possibly a penalty. In both cases, penalties will be avoided if the employee is age 59½ or older and can withdraw from the account. In the case where an employee quits, penalties may be avoided if the balance is paid back within 60 days.

If you're considering borrowing from your 401(k), it's a good idea to check all the rules and all your options before moving ahead. ■

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dividends. This double taxation can be a disadvantage, particularly for owners who are not in a position to reinvest a significant portion of profits back into their business.

One advantage to this structure for businesses is the protection it offers from personal liability. Owners are personally shielded from debt liability and lawsuits against the company; only the amount of their investment is at risk.

S Corporations

S corporations, which limit ownership to 100 shareholders, share characteristics of C corporations and partnerships. This form of **pass-through entity** generally does not pay corporate income tax and permits the shareholder to treat company earnings and profits as distributions. This income depends on the shareholder's

percentage of ownership and passes through directly to his or her personal tax return, thereby avoiding double taxation and self-employment tax. Shareholders may also deduct losses, limited to their basis in the business. State tax treatment may vary.

As with C corporations, shareholders are protected from personal liability. Only their investment in the company is at risk.

LLCs

A limited liability company (LLC) provides the limited liability benefits of a corporation and the tax efficiencies and operational flexibility of a partnership. Members of an LLC are protected from personal liability, risking only their investment in the company. Most states require LLCs to have at least two members, but there is no maximum limit.

An LLC's profits and losses pass through to members, who then pay income tax on these distributions. Because LLCs are pass-through entities, they are not subject to federal tax at a corporate level, provided they have more partnership than corporate characteristics. The Internal Revenue Service (IRS) classifies an entity as a partnership if it lacks at least two of the following four corporate characteristics: limited liability, centralized management, continuity of life, and free transferability of interests. State tax treatment may vary.

As you can see, each business structure has its advantages and disadvantages. Your choice will affect the taxes you pay and your personal liability risk, so it is important to choose the right entity for your business. ■

Business Entity	Tax Treatment	Liability Risk
Sole Proprietorships	Income is subject to individual rates of 10% to 35%, plus self-employment tax. Reported on Schedule C of Form 1040.	Personal liability for all aspects of the business.
Partnerships	No federal tax on business entity. Income and expenses are allocated among partners, and each pays tax of 10% to 35% (plus self-employment tax, if applicable) on their share of partnership profits whether distributed or not. Losses pass through to partners. Restrictions on loss deductibility apply.	Personal liability rests with each general partner. Limited partners assume liability no greater than the capital they contributed.
C Corporations	Federal marginal tax rates from 15% to 39% with an overall maximum rate of 35%. Possibly taxed again at distribution. Shareholders pay tax on dividends. Losses do not pass through to shareholders.	Shareholders are shielded from personal liability for business debts. Only their investment is at risk.
S Corporations	Generally, no federal tax on the business entity. Income and expenses are allocated among shareholders. Taxable income is subject to individual rates from 10% to 35%, whether profits are distributed or not. Losses pass through to shareholders. Restrictions on loss deductibility apply. State treatment of S corporations may vary.	Shareholders are shielded from personal liability for business debts. Only their investment is at risk.
LLCs	No federal tax on business entity. Income and expenses are allocated to members or partners, and each pays tax of 10% to 35% (plus, self-employment tax, if applicable) on their share of LLC profit whether distributed or not. Losses pass through to members or partners. Restrictions on loss deductibility apply.	Members or partners are shielded from personal liability for business debts. Only their investment is at risk.

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 your financial goals face 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 by a *regular gifting program*.

Current tax laws allow you to give away \$12,000 (\$24,000 if married) per year to as many people as you wish *without* incurring any gift taxes. This \$12,000 **annual gift tax exclusion** can be an effective means for gradually passing wealth to future generations. In fact, the systematic use of making such a gift can create a rather sizable long-term result.

Consider this hypothetical example: Suppose Joseph Smith (age 60) starts a gifting program for his newborn grandson Alex. Each year, Joseph makes a gift of \$12,000. After 25 years, Alex will have accumulated \$300,000, assuming 0% growth. In addition, suppose Joseph's wife Helen (age 60) also chooses to make a \$12,000 gift to Alex, bringing the total annual gift to \$24,000. In this case, Alex will have accumulated \$600,000 in 25 years (assuming 0% growth). With this win-win scenario, the Smiths help Alex accrue a nest egg, while, at the same time, lowering the value of their estate. This strategy will help the Smiths minimize their estate tax liabilities.

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 Smith. Suppose Joseph (the donor) sets up an **irrevocable life insurance trust (ILIT)** for the benefit of Alex. The ILIT then purchases life insurance on the life of 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). While over the long term, life insurance offers individuals 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. ■

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of marital property. Consult your attorney for legal advice.

If you donate an item to a charitable organization, an appraisal may be needed to show the IRS that the charitable donation is worth what you claimed on your tax return.

The IRS generally requires a qualified appraisal for deductions over \$5,000 claimed for a single item or a collection of similar items, such as coins. Consult your tax professional for more information.

Appraisals may play a *valuable* role in your overall financial strategies. They can help you determine your insurance coverage, as well as your estate and tax strategies. Consider appraising your prized possessions before the need arises. ■

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.