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The “Kiddie Tax” Grows Up Fast

The \$70 billion tax bill signed into law on May 17, 2006, the Tax Increase Prevention and Reconciliation Act (TIPRA), delivered a tax increase to families with investment income. This reform expanded the “kiddie tax” by raising the age limit from 14 to 18. Up until age 18, investment income for children exceeding \$1,700 will now be taxed at the parents’ generally higher rates.

For many families, this sudden change affects their tax-efficient investing strategies, particularly those developed to help fund a college education. While the reform does not affect the taxation of 529 plans or Coverdell Education Savings Accounts (ESAs), it does affect custodial accounts and investment holdings that generate taxable income.

The Tax Impact

The kiddie tax kicks in when investment income exceeds \$1,700 for children under age 18. They do not pay tax on the first \$850 of investment income, but they do pay tax at their own rate on the next \$850. Any unearned income above \$1,700 is taxed at the parent’s rate. For long-term capital gains, the top rate is 15%, while the top marginal income tax rate is 35%. A special rule exempts teens who are under 18 but are married and filing a joint return. Bear in mind that the kiddie tax only applies to a child’s unearned income; wages from employment are exempt.



For illustrative purposes, let’s suppose your 16-year-old daughter has \$5,000 of interest income. Under current rules, she pays no tax on the first \$850 and then 10% on the next \$850. The remaining \$3,300 is taxed at your rate, and let’s assume it’s 35%. The tax on her income would total \$1,240. Under the old rules, her tax would have been \$415.

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Building the Value of Your Business

Caught up in the day-to-day issues involved in running your business, you may not be thinking about how much your company could, ultimately, be worth when the time for a transition arrives. But the choices you make now, both large and small, can add to or detract from the future value of the company. While changing market conditions will demand flexibility, your exit plans should inform your current growth strategy.

There are many ways for a company to grow, including entering new markets, developing new products, acquiring complementary businesses, hiring more employees, and increasing sales and marketing expenditures. An owner may attempt to grow the business rapidly by tapping into outside financing or to expand organically using the company's own revenues. With so many strategies to consider, you should develop a long-term plan to guide your business as it grows.

Your decision regarding the ultimate disposition of the company will influence what business form you choose. It may, for example, make sense to opt for a C corporation structure for a business that may go public or an S corporation form if a private sale is planned.

Transferable Assets

Work on building and maintaining transferable assets. These may include not only property and equipment, but also intangibles, such as a customer base, a solid reputation, brand recognition, and business processes. Depending on the type of business

you operate, your firm's intangible assets could prove to have substantial value at the time of transition. Distinct intangible assets include copyrights or trademarks, proprietary lists of customers or prospects, and long-term contracts. The value of the business in excess of the owner's equity is known as goodwill; this may include assets such as an attractive location or customer awareness.

Companies also derive intangible benefits from having a strong management team with the knowledge and connections required to maintain the business after the owner retires.



In many cases, having a skilled and loyal workforce can also be considered a transferable asset in a sale.

Financial Performance

When growing your business, your goal should be to establish a self-sustaining enterprise with steady revenue growth. The financial performance of a company is often measured by its free cash flow, or the cash that a company generates before interest, taxes, depreciation, and amortization minus capital expenditures. In assessing the value of the company, a buyer may, for example, project a company's earnings over the next five years based on the current cash flow.

This projection will take into account any outstanding debt, as well as whether revenue growth and margins have a history of consistent growth.

Regardless of your time frame for transitioning the business, you should regularly review the products and services your company offers. Businesses are often more efficient when they focus on their core competencies, rather than diversifying too broadly. If your company has product lines or offers services not closely aligned with the firm's core business, consider whether these areas are profitable or represent a drag on the company's resources. Selling off non-core assets may also be a useful means of paying off debt.

You may also want to restructure agreements or contracts that may be objectionable to a potential buyer, such as a long-term lease, licensing contracts, employment contracts, and loan agreements. On the other hand, you may need to formalize verbal agreements to ensure the business' relationships with key customers or suppliers continue after the transition.

Plan ahead before you sign a lease. Long-term leases are an asset provided the terms are favorable, the location is suitable, and the size is right. If, however, the company is likely to grow out of its facilities before the lease is up, or if potential buyers may want to move the firm's operations, a short-term lease may be more appropriate.

If you want a more detailed analysis of your company's value, call in professional business appraisers familiar with your industry. Even if you have no immediate plans to leave the company, an estimate can help you identify ways to maximize the value of the business in preparation for a future exit. ■

Between a Rock and a Hard Place: Minimizing Both Estate and Income Taxes

If your estate is worth between \$2 million and \$3.5 million, estate planning has become a lot more complicated than it was before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). How so? Over the next few years, the amount that can pass tax free at death to your heirs increases (see chart).

Scheduled Estate Tax Changes

2007 & 2008	\$2,000,000
2009	\$3,500,000
2010	Repeal
2011	\$1,000,000

While the increasing estate tax exemption is good news for taxpayers, there are several things to keep in mind when planning to minimize estate taxes.

1. Although the estate tax is slated for repeal in 2010, it will be reinstated in 2011 (with a \$1 million exemption and a top estate tax rate of 55%) unless Congress makes the repeal permanent.
2. Although the exemption for estate taxes increases, the amount that can be “gifted” during a lifetime without paying gift tax remains at \$1 million, even after repeal of the estate tax.
3. For deaths prior to 2010, the income tax basis of assets owned at death will be adjusted to their current fair market value (FMV). Typically, this results in significant income tax savings for the heirs when the assets are sold. In 2010, this basis “step-up” will be limited.

What about Bob?

Consider the hypothetical case of Bob, a recent widower. Bob’s estate

is worth \$3 million, and he plans to leave everything to his children. His assets have appreciated substantially in value since he acquired them, and he expects that trend to continue.

If Bob were to die in 2007, it’s very likely his heirs would incur a significant estate tax bill, since only \$2 million would be sheltered by his estate tax exemption. Even if he lives beyond 2007, the appreciation of his assets may overtake the increase in the exemption.

If estate taxes were the only consideration, Bob might decide to make gifts to his children, at least to the extent of the annual exclusion (\$12,000/person in 2007), and possibly use a portion of his \$1 million gift tax exemption to remove future asset appreciation from his estate. But estate taxes are not the only consideration. If Bob gives his children an asset that has appreciated in value, the income tax basis of the asset carries over to them, and they will have to pay income tax when the asset is eventually sold, assuming it doesn’t decrease in value. On the other hand, if Bob owns the asset when he dies and his children inherit it, the basis will be adjusted to fair market value (FMV) at that time.

Therein lies a dilemma: a) If Bob gives away assets which would have been sheltered from estate tax by

future increases in the exemption, he has “wasted” the opportunity to have the income tax basis of those assets increased upon his death; b) on the other hand, if Bob owns assets at death worth more than the available estate tax exemption, there will be an estate tax liability.



What to Do?

Death tends to come on its own timetable.

So how can you plan for the inevitable with frequently changing legislation? There is, unfortunately, no perfect answer to this problem since a lot depends upon personal circumstances, but here are a few ideas to consider:

1. Make gifts of “high basis” assets (basis close to or above current market value) first. This will minimize the loss of income tax benefits from the basis step-up at death.
2. Avoid making gifts that will reduce your potential taxable estate below the available estate tax exemption.
3. Think about using a family limited partnership (FLP) or limited liability company (LLC) as a hedge against estate taxes and income taxes.

And of course, your first course of action should be to consult with your legal and tax professionals. They can help you navigate the nuances of tax laws for the benefit of both you and your heirs. ■

the “kiddie tax” grows up fast

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In order to take advantage of their children's lower tax brackets, many parents shifted appreciated stock to their kids. The children would then sell the assets, oftentimes to pay for college expenses, and pay tax at their own, likely lower, rates. In 2007, taxpayers with income less than \$31,850 pay only 5% on long-term capital gains and qualified dividends. From 2008 through 2010, taxpayers in the bottom tax brackets pay zero tax on long-term gains and dividends.

With the kiddie tax's new bump up in age, these asset-shifting plans now have different tax consequences.

Rather than owing 5% tax on long-term gains for their college-bound kids, unsuspecting families may now owe 15%. Furthermore, any plans to take advantage of the zero-tax window will have to be revised.

Financial Aid Considerations

When it comes to financial aid, there are definitely advantages to keeping money earmarked for education out of your child's name. Colleges

generally expect 35% of a student's assets to be dedicated to education,

whereas the expectation for parents is lower—only 6% of your assets are considered in the funding formula for aid. The less savings children have in their own names, the more aid they may receive, depending on the cost of attendance and your family's overall financial situation.

Be sure to consult with your legal or tax professionals for specific advice on this matter. ■



Favorable Reform for Health Savings Accounts

In a nod to health care reform, the Tax Relief and Health Care Act of 2006 permanently enhances tax incentives for Health Savings Accounts (HSAs). Employees who have a health Flexible Spending Arrangement (FSA) or a Health Reimbursement Arrangement (HRA) can make a one-time, direct transfer to an HSA through December 31, 2011. Furthermore, beginning in 2007, employees can make a one-time transfer from an Individual Retirement Account (IRA) to an HSA. The amount is limited to the maximum deductible contribution amount of the high-deductible health

plan (HDHP), based on the employee's coverage.

In addition, contributions to an HSA are no longer limited to the an-



nual deductible of the HDHP. As a result, in 2007, the maximum contri-

bution is \$2,850 for self-only coverage and \$5,650 for family coverage.

The legislation also repeals the prorated contribution limits that applied to HSAs created in the middle of a tax year, allowing taxpayers who start accounts during the year to make the full annual contribution. Furthermore, the requirement that employers make comparable contributions to the HSAs of all employees has been repealed. Under the new law, employers are allowed to make larger contributions to the HSAs of lower-paid employees than to the accounts of highly compensated employees. ■

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.