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Asset Protection at a Glance

Many people focus their efforts on increasing their financial resources, yet they may give relatively little attention to *protecting* those assets once they are accumulated. However, without the proper legal protection, the financial security you have worked long and hard to build could easily be threatened by an unexpected lawsuit.

In today's litigious society, it is not only the wealthy who should be concerned. Even individuals of moderate means, who have home equity, savings, or retirement accounts could be at risk. Business owners and professionals, such as doctors, dentists, lawyers, and accountants, may be especially vulnerable to claims from customers/patients/clients, suppliers, employees, and lenders.

Lawsuits can be expensive and time-consuming to defend. Even if you think you are in the right, you may be forced to settle, because it may be more costly to fight a lawsuit than to pay a settlement. Also, regardless of whether you win or lose, you must generally pay for the costs of your own defense. However, with proper advance planning, there are some relatively simple and inexpensive ways to help protect your assets from the threat of litigation.

Life Insurance

In many states, **life insurance death benefits** and **cash values** are exempt (in whole or in part) from the claims of creditors of the insured. However, the exemption for life insurance cash values may depend on the ability to prove there is no attempt to defraud a creditor.

Qualified Retirement Plans

You may also want to consider maximizing your contribution to your qualified retirement plan. In order to be tax qualified in the eyes of the Internal Revenue Service (IRS), qualified plan assets may not be assignable. The United States Supreme Court has interpreted this to mean that account balances in a qualified plan are generally protected in bankruptcy situations. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) strengthened this legal principle by explicitly extending bankruptcy protection to retirement savings held in Individual Retirement Accounts (IRAs). Non-rollover assets of up to \$1 million held in tax-favored retirement accounts, including IRAs, are protected under BAPCPA in the event of personal bankruptcy. There is no exemption limit on amounts rolled over to

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Survivorship Life: A Win-Win Proposal

One of the more flexible and creative products to enter the insurance arena is **survivorship life insurance**. Often referred to as *last-to-die* or *second-to-die* life insurance, this coverage insures *two* individuals but provides only one death benefit payable at the death of the second insured. In some instances, especially when the insured individuals are nearing retirement, it may be less expensive than a single life insurance policy on one individual.

Cost savings are made possible because the insurance risk is spread over the life expectancy of *two* lives rather than one. In fact, two individuals can be insured even if one is medically “uninsurable,” thus providing added security and planning potential for otherwise difficult situations.

Benefits for Estate Planning

The advent of survivorship life insurance has created several exciting personal planning opportunities, the most popular of which is the funding of estate taxes. Even with the appropriate wills, trusts, and property ownership designations, married individuals who properly balance their estates are still subject to estate tax on assets exceeding the **applicable exclusion amount** of \$2,000,000 per person in 2008. In this type of situation, a survivorship life insurance policy can be an integral part of an estate plan.

Let’s take the hypothetical example of Jane and Rick Sanderson. Jane and Rick are both sixty years of age and have three adult children. The Sandersons have updated and signed the appropriate legal documents (**wills, trusts, etc.**) and repositioned their

asset ownership to maximize their individual applicable exclusion amounts. Thus, the potential exists for only \$4,000,000 in 2008 to pass to their heirs free of estate taxes. However, the remainder of their assets may incur as much as a 45% federal estate tax.

One solution to this problem would be to create an **irrevocable trust** to purchase a survivorship life insurance policy on their lives. The trust will own and be the beneficiary of the policy and, thus, will allow the policy proceeds to pass to the trust beneficiaries (the Sandersons’ children) estate tax free. The Sandersons **gift** the policy premiums to the trust using their **annual gift tax exclusions** of \$12,000 (indexed for inflation) per person per



donee for 2008. In order to qualify for the annual exclusion, the trust contains **Crummey withdrawal powers**.

Enhance Charitable Gifting

Even if an individual does not foresee any estate tax problems, survivorship life insurance can be a dynamic method used to enhance any gifting program. Suppose the Sandersons’ net assets total \$600,000 and they have little concern about estate taxes. How-

ever, they make an annual gift of \$5,000 to a favorite local charity. Rather than gifting \$5,000 in cash to the charity every year, the Sandersons may choose to leverage their gift and pay the premium on a survivorship life insurance policy. This insurance gifting program is arranged so the charity is the owner and beneficiary of the new survivorship life policy. The Sandersons will then receive an annual charitable deduction for their generous gift, and the charity will ultimately receive a life insurance death benefit.

Maintaining Business Continuity

In a more advanced use, survivorship life insurance can be effective in helping to ensure continuity in a **closely held** business. For instance, passing a family-owned business of substantial value to heirs may be hampered by potentially hefty estate taxes that, in some instances, may require a forced sale of the business in order to raise the necessary cash to pay the taxes. A survivorship life insurance policy can be purchased on the lives of the owner and his or her spouse, with the death benefit providing cash to help meet estate tax obligations and keep the business in the family.

The many uses of survivorship coverage can result in a “win-win” situation for the insured individuals and their family. Whether you have an estate tax problem or wish to leverage the value of a gift to your favorite charity, a survivorship policy can help provide a relatively high benefit for a minimal cost. A consultation with your qualified insurance professional can best determine how a survivorship life insurance policy can fit into *your* overall financial program. ■

Tax Breaks for Landlords

Like many Americans, you may be thinking of investing in a home or condo that has the potential to appreciate over time while generating a steady stream of rental income. Property investment can be risky given the fluctuations in the real estate market, but the federal government has made buying residential properties for rental purposes more attractive by providing landlords with tax breaks not available to owners of personal residences. If you are considering investing in a rental property, the potential for saving money on your tax bill should figure into your cost-benefit analysis.

Deducting Expenses

Provided the house or apartment is offered for rent at fair market value for most of the year, the property owner is entitled to claim expenses associated with operating and maintaining the residence. As a landlord, you are permitted to deduct mortgage and other interest paid for the rental property, as well as insurance costs, real estate taxes, utilities, and homeowners' association fees.

Rental property owners are also entitled to deduct the cost of basic home repairs. Generally, the IRS defines a repair as an action taken to keep the property in good operating

condition, such as repainting the interior or exterior walls, replacing a window pane, or fixing a leaky pipe. Major improvements undertaken to add to the property's value, extend its useful life, or adapt the property to new uses are not immediately tax deductible, but they may be depreciated. Examples of improvements include adding a room or deck, putting in storm windows and doors, laying carpeting, and upgrading wiring.

Landlords are permitted to recover the cost of improvements over their useful lives as defined by the IRS. The building itself may be depreciated over a period of 27.5 years. While this may seem like a long time, it is much shorter than the 39-year depreciation period that applies to commercial properties. The depreciation deduction is particularly advantageous considering that residential properties tend to appreciate in value over time.

As the owner of a residential rental property, you may also qualify for many of the same tax breaks available to business owners. Rental property owners are, for example, generally permitted to write off the cost of advertising and marketing the rental property, office- and computer-related expenses, mileage on travel to and from the residence, commissions to rental agencies, and payments to

cleaning crews. Loss of rental income because the property is empty for a period of time is not deductible, but you can deduct expenses incurred while actively seeking a tenant.

Passive Loss Rules

There may, of course, be times when the expenses associated with managing and maintaining the property exceed your rental income. Because income from rental activities is usually classified as passive income for tax purposes, deducting losses can be more complicated for landlords than for other business owners. Under the IRS's passive loss rules, taxpayers are only allowed to offset passive losses against passive income from other sources, such as rental income from another property. The rules do not allow landlords to claim a passive loss against "nonpassive" income from a job or business, or against portfolio income from investments.

Depending upon your financial circumstances, you may, however, qualify for an exception to the passive loss rules. The IRS permits a deduction of up to \$25,000 in passive losses by landlords who have a modified adjusted gross income (MAGI) of less than \$100,000 and can demonstrate that they "actively participate" in the rental activity. Active participation

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Determining Your Gross Estate

In order to minimize estate taxes, it is important to understand what assets and property constitute your **gross estate**. Among those often overlooked items that are includable in your estate are your rights to *future* income, such as your right to payments under a deferred compensation agreement or partnership income continuation plan. Likewise, your interests in



any business you own at your death are includable in your gross estate. In addition, your personal property, investments, real estate, retirement plans, and proceeds of life insurance policies that you own are also included. However, the value of Social Security survivor benefits, either lump sum or monthly annuity, are excluded from your gross estate. ■

asset protection at a glance

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IRAs from qualified plans, including 401(k)s. Funds held in SEP IRAs and SIMPLE IRAs also gained unlimited protection from creditors under the legislation, and are not counted toward the \$1 million IRA limit.

Primary Residence

Life insurance policies and qualified plans aren't the only ways to protect assets. Most states provide some kind of asset protection for a primary residence. The key may lie in *how* the residence is titled. One form of titling called "**tenants by the entirety**" is often necessary to insulate home equity against the claims of creditors.

Trust Funds

In some cases, a "**spendthrift**" clause in a trust will prevent creditors from attacking trust fund assets. How-



ever, this protection almost never applies in the case of so-called "**self-settled**" trusts. In other words, you cannot typically set up a trust for your own advantage, unless you cede all

control and benefits. It may, however, be possible to establish such a trust to benefit selected family members.

The Bottom Line

When planning your estate, it is important to give thought not only to building wealth, but also to protecting your assets from the threat of lawsuits and the potential claims of creditors. Some relatively simple and inexpensive strategies may exist to achieve this end. However, it is important to bear in mind that asset protection planning is a complex topic and may require the assistance of qualified legal and tax professionals. ■

tax breaks for landlords

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generally means owning at least a 10% stake in the property and taking an active role in decisions relating to the management of the property, such as selecting tenants and approving repairs. The exception phases out gradually for landlords with MAGIs between \$100,000 and \$150,000. If your MAGI is above \$150,000 and you have no passive income to offset a loss from your rental activities in a given tax year, you are permitted to carry over the loss to future tax years, when you may have positive passive income to report. You can also offset passive losses not allowed in previous tax years against gains from selling the property.

Despite these restrictions on claiming deductions for losses, collecting rental income does offer a distinct tax advantage over other types of earnings: Unlike active income from a business or job, passive income is not subject to payroll or self-employment taxes, which can run as high as 15.3%.

The tax implications of becoming a landlord will vary greatly depending upon your overall financial situation, the amount of income you can expect to receive from your property, and the amount of time the property is rented out to each tenant. For example, renting out a

property for only part of the year or for only very short periods of time will affect the way you are taxed. Different rules apply to full-time real estate professionals than to part-time landlords.

Residential real estate can be a sound investment over time. But before deciding you are ready to take on the responsibilities that come with renting out a home, it is important to weigh likely expenses against potential income—and consider how your new identity as a landlord will affect you at tax time. ■

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.