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An economic and investment update

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Disability and the American Business

Many business owners have **life insurance** to protect their families financially in the event of their death. They also have **property and casualty insurance** to protect the value of their personal belongings in the event of damage, fire, or theft. However, many business owners often overlook, and therefore do not insure, one their most valuable assets: their ability to earn an income.

Increasing Awareness

A lack of awareness about the possibility of sustaining a disability leaves many business owners, as well as their businesses and their families, vulnerable to financial challenges. Despite the risk, many small businesses lack disability insurance.

If you were to sustain a disability that prevents you from working, how would you pay for housing, insurance, food, transportation, clothing, etc.? Would your business be able to continue generating income? Do you have money in savings to support yourself and your family during a six-month disability or

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Congress Approves Two-Year Extension of Lower Tax Rates

Putting to rest concerns that the new year would begin without long-anticipated legislative action on tax rates for 2011, on December 17, President Barack Obama signed into law an $858-billion package that includes a two-year extension of reduced tax rates on individual income and dividends/capital gains. In addition, the law includes extensions and enhancements of a number of tax breaks for small businesses, a two-year AMT patch, estate tax relief through 2012, and a one-year reduction in payroll taxes.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) was approved by Congress after a prolonged debate about whether to extend the income tax reductions passed in 2001 and 2003, which were due to sunset at the end of 2010, to all taxpayers or only to those earning less than $200,000 for individuals or $250,000 for families. In early December, President Obama announced that the White House had struck a deal with Congressional leaders, with both parties agreeing to a two-year extension of the current individual income rates for all taxpayers and estate tax relief. In exchange, President Obama asked that Congress support a 13-month extension of unemployment benefits and payroll tax relief.

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Disability and the American Business

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an extended illness? Or, if an employee was suddenly disabled, would you be able to fund disability benefits for that employee?

A Cost-Effective Solution

There is a reasonably simple and cost-effective solution to such situations. Business owners may establish a **wage continuation plan** for themselves and their employees. Such plans can help ensure that owners and employees can continue to be paid during a long-term disability. Consider the following advantages:

- If structured properly, the payment of benefits to a disabled employee or owner may qualify as "necessary business expenses." Under Section 162 of the Internal Revenue Code, they may be tax deductible.
- A wage continuation plan can promote loyalty among current employees and attract new employees.

Once a commitment has been made to establish a wage continuation plan, the next step is to decide how to fund it. Possible funding options include current revenue, retained earnings, or borrowing. Unfortunately, such funding options may create financial challenges. However, a disability income insurance policy can provide distinct benefits, such as the following:

- Policies transfer the risk of salary continuation from the employer to the insurance company. In effect, a potentially open-ended expense is replaced with a leveraged, fixed business expense—the premiums.
- When a qualified wage continuation plan is funded by a disability income insurance policy, the policy premium may be tax deductible as a business expense. To create a qualified wage continuation plan specific to a business and its needs, owners are advised to consult with their qualified legal counsel.

If a business pays the premiums for a disability income insurance policy, the business may be able to deduct the premium payments as a regular business expense, provided such contributions are reasonable. Although the premiums are not considered taxable income to the employee, any disability income insurance proceeds received by the employee generally would be taxable income. Disability income benefits received from a policy during the first six months of a disability may be subject to Social Security tax (FICA) and Federal unemployment tax (FUTA).

However, if you are a **sole proprietor**, a **partner** in a partnership, or a more than 2% stockholder in a **subchapter S corporation**, you may not be able to deduct the cost of disability income insurance for yourself as a business expense, but you may be able to deduct the cost of such insurance coverage for your employees.

Customizing a Policy

Generally, disability income insurance policies can be tailored to meet specific needs, often with riders, which may be available at an additional cost. Total cost for the policy is generally determined by the type and extent of coverage. For example, "own" occupation coverage (benefits would be paid for a disability that limits one's ability to work in one's chosen occupation) is generally more expensive than "any" occupation coverage (benefits would be paid for a disability that limits one's ability to perform any gainful work).

The length of the **elimination period** (the waiting period before benefit payments begin) and the maximum benefit provided (stipulated by dollar amount, length of time, or a combination of both) are other significant variables in plan design and cost.

One area often overlooked in business disability planning is the completion of retirement funding for an owner who has sustained a disability. What happens when there are no contributions to an eligible retirement plan resulting from a disability? This problem may be addressed by purchasing a disability income insurance policy designed to help fund a shortfall in contributions to an eligible retirement plan resulting from the disability.

Key person disability insurance and **business overhead expense policies** are two other important coverage options. Key person disability insurance provides a monthly benefit to the business based on the key employee's pre-disability earned income. The benefit can then be used to provide revenue to hire and train a replacement or to strengthen the company's cash flow. The second option, a business overhead expense policy, can help pay for overhead expenses should you become disabled under the terms of the policy. Thus, if you are temporarily unable to generate revenue, the policy provides funds to reimburse specific business expenses, helping to keep the business operating without interruption.

The key to proper design begins with a realistic understanding of the risks associated with a disability. The appropriate policy may allow you and your business to help mitigate the challenges associated with a disability. $

Offset the Effects of Inherited Wealth with Incentives

For many affluent individuals, estate planning extends well beyond 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 vehicle for distributing trust income, while limiting immediate access to trust principal.

A spendthrift trust can help provide a financial head start for minor children and protect adult heirs from certain creditors and limitations in financial 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 choose to establish 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 guides trustees in the implementation of an affluent grantor's expectations regarding the 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 based on a series of pre-determined "incentives."

Promoting Success and Reinforcing Values

The incentives outlined in a FIT are at the discretion of the grantor. Each incentive provides the grantor with the opportunity to encourage specific, future behavior. For instance, the trust could have provisions that pay each heir $10,000 upon 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 tool 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. A FIT can reward younger heirs for academic success or community involvement. In addition, the trust can match certain levels of income for heirs who are younger than a specified age.

A FIT may also be an appropriate vehicle for education funding. Unlike a custodial account, which generally becomes the property of the child once he or she attains the age of majority (determined by state law), a FIT can dictate that some trust assets be used to help cover education costs. Thus, the trust—rather than a young, inexperienced adult—can maintain control of monies earmarked for education.

Another interesting utilization of a FIT is using trust principal as a "family bank." The FIT can offer low interest rate loans for start-up business ventures or the purchase of a primary residence. To minimize risk to the trust, a lending process similar to that of a traditional lending institution can be established.

Philanthropy creates another possibility for an incentive-based estate plan. Certainly, many affluent individuals consider philanthropic pursuits to be 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 his or her contribution, as well as the FIT's matching contribution. As an alternative, any remaining trust income that has not been distributed through incentives may be used to make a charitable contribution. Such contributions can also be arranged to be made on behalf of trust beneficiaries.

Sometimes, the effects of inherited wealth can have a negative impact on the motivation of heirs. For instance, when some heirs receive a substantial inheritance, they may be content with a life 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 promote a family legacy of excellence and productivity for generations to come. $

Congress Approves Two-Year Extension of Lower Tax Rates

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Among the main provisions of the new legislation are the following:

- **Income tax rates extended through 2012.** Under the 2010 Tax Relief Act, lower individual income tax rates (10%, 15%, 25%, 28%, 33%, and 35%) are extended through 2011 and 2012. These rates went into effect under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but had been scheduled to revert to their previous levels (15%, 28%, 31%, 36%, and 39.6%) after 2010. The associated changes in itemized deduction and personal exemption rules are also extended for 2011 and 2012, including a two-year continuation of the repeal of the personal exemption phaseout (PEP) and the repeal of the limitation on itemized deductions ("Pease" limitation) for higher-income taxpayers.

- **Tax rates on capital gains and dividends extended through 2012.** As a result of recent tax reform, in 2010, qualified capital gains and dividends were taxed at a maximum rate of 15%, and taxpayers in the 10% and 15% income tax brackets paid no tax on qualified capital gains and dividends. Under the 2010 Tax Relief Act, these rates are extended through 2012. Had no legislative action been taken, the maximum capital gains rate would have risen to 20%, and qualified dividends would have been taxed at ordinary income tax rates, with a top rate of 39.6%.

- **Child tax credit extended through 2012.** Under the 2010 Tax Relief Act, the $1,000 child tax credit is continued through December 31, 2012, as are recent enhancements to the credit. Under EGTRRA, the credit amount had been scheduled to revert to $500 after 2010.

- **Marriage penalty relief continued through 2012.** Under EGTRRA, the basic standard deduction for a married couple filing jointly was increased to twice the amount for a single filer, and the 15% income tax rate bracket for married couples filing jointly was also expanded to twice that of single filers. The new law extends this marriage penalty relief for two years, through December 31, 2012.

- **Payroll tax reduced for 2011.** For wages earned in calendar year 2011, the employee share of payroll taxes is lowered from 6.2% to 4.2%, up to the taxable wage base of $106,800. Self-employed individuals owe 10.4% on self-employment income up to the threshold.

- **AMT relief provided for 2010 and 2011.** Under the 2010 Tax Relief Act, the exemption amounts for the Alternative Minimum Tax (AMT) are increased for 2010 and 2011. For 2010, the exemption amounts are raised to $47,450 for singles, $72,450 for married couples filing jointly, and $36,225 for married couples filing separately. For 2011, the equivalent amounts are $48,450, $74,450, and $37,225. Without this "patch," an additional 21 million households may have faced a tax increase, as the exemption amounts would have fallen to $33,750 for individuals, $45,000 for married couples filing jointly, and $22,500 for married couples filing separately.

- **Education tax breaks extended through 2012.** The 2010 Tax Relief Act extends through 2012 a number of education-related tax incentives at their 2010 levels, including Coverdell Education Savings Accounts, the student loan interest deduction, the Section 127 exclusion from income for employer-provided education assistance, and the American Opportunity Tax Credit for college tuition.

- **Tax breaks for families continued through 2012.** Under EGTRRA, the dependent credit available to parents or family members to help pay for care for a child under age 13 or for a disabled dependent or spouse was temporarily increased to up to $6,000 per family. The 2010 Tax Relief Act extends this increase for two years, through December 31, 2012. Other existing breaks for families that are extended through 2012 include the adoption tax credit, the employer-provided adoption assistance program exclusion, the employer-provided child care tax credit, and the earned income tax credit.

- **Individual extenders continued through 2011.** Under the 2010 Tax Relief Act, a number of temporary individual tax incentives are extended through 2011, including the state and local sales tax deduction, the higher education tuition deduction, the teacher's classroom expense deduction, and the charitable contributions of IRA proceeds.

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- **Estate tax returns with a top rate of 35% and an exclusion of $5 million.** Under EGTRRA, the Federal estate tax was gradually reduced and disappeared altogether in 2010, but it was scheduled to be reinstated in 2011 at pre-2002 levels. Under the 2010 Tax Relief Act, the estate tax returns with a maximum tax of 35% and an exclusion amount of $5 million for 2011 and 2012 only. The new law also eliminates the modified carryover basis rules that were in effect in 2010 and replaces them with stepped-up basis rules.

  In addition, the 2010 Tax Relief Act provides estates of decedents dying in 2010 with the option to elect not to come under the revived estate tax rules. These estates may choose to apply the estate tax based on 2011 rates, with stepped-up basis rules, or no estate tax, with modified carryover basis rules.

  Starting in 2011, the gift tax is reunified with the estate tax, with a top tax rate of 35% and exemption of $5 million. Starting in 2011, the generation-skipping transfer (GST) tax is equal to the highest estate and gift tax rate in effect for the year (35% for 2011 and 2012).

- **Energy tax credits for individuals and businesses extended.** Many of the energy credits and deductions set to expire at the end of 2010 are extended for one or two years under the new legislation, including business credits for biodiesel and renewable diesel fuel, the credit for refined coal facilities, the new energy-efficient home credit for builders and manufacturers, tax credits for alternative fuel and alternative fuel mixtures, and the credit for the purchase of energy-efficient appliances.

  In addition, individuals who make certain energy efficiency improvements to their homes are eligible to claim tax credits worth up to 30% of their investment, up to a total lifetime limit of $1,500, for products or improvements placed in service through December 31, 2011.

- **50% bonus depreciation raised to 100%.** Under recent tax reform, qualified businesses were given the option of depreciating 50% of the adjusted basis of the property for qualifying property bought and placed in service in 2008 through 2010. The 2010 Tax Relief Act increases the 50% bonus depreciation to 100% for qualified investments made after September 8, 2010 through December 31, 2011, and it also makes 50% bonus depreciation available for qualified property placed in service through December 31, 2012. In addition, certain long-lived property and transportation property is eligible for 100% expensing if placed in service before January 1, 2013.

- **Section 179 expensing extended through 2012.** For 2010 and 2011, businesses are permitted under the Small Business Jobs Act of 2010 to expense up to $500,000 of Section 179 property, and the amount that may be expensed is reduced only if the cost of the Section 179 property exceeds $2 million. Under the 2010 Tax Relief Act, a $125,000 dollar limit (indexed for inflation) and a phaseout beginning at $500,000 (indexed for inflation) is in effect for 2012. After 2012, the limit reverts to $25,000, with a phaseout beginning at $200,000.

- **Research tax credit extended through 2011.** The Code Section 41 research tax credit, which had expired at the end of 2009, is continued for two years, through December 31, 2011.

- **Extension of the Work Opportunity Credit (WOTC).** The WOTC, which provides businesses that hire members of certain "targeted groups" with a credit of up to $2,400 on the qualifying first-year wages paid to each employee, would have expired after August 31, 2011. Under the 2010 Tax Relief Act, the WOTC is extended for new hires who begin employment after August 31, 2011 and before January 1, 2012, though certain groups who had previously been targeted no longer qualify for this credit.

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Estate Planning before Remarriage

Despite the best intentions, marriages don't always last forever. If you are divorced or widowed, and planning a second marriage, you may want to take the opportunity to review and revise your estate conservation strategies. This is especially important if you and your future spouse have children from previous marriages. Consider the following points:

1) Regardless of the details of your situation, it is important to be aware of the potentially sensitive aspects of estate planning. When multiple families are involved, objective professional counsel may help you achieve your desired results.

2) Familiarize yourself with the advantages and disadvantages of different types of asset ownership. If you would like your assets to pass entirely to your children, you may want to put them in your own name. It is important to know that new assets acquired in **joint tenancy** with your spouse will automatically be passed on to the surviving spouse.

3) Consider a pre-marital agreement to legally detail your property arrangements. While you may feel ambivalent about broaching this subject, a formalized agreement can help facilitate your wishes.

4) Review your **will** and update the beneficiary arrangements of your **life insurance policy** to ensure that your property is distributed according to your wishes upon your death.

As you prepare for and experience major life changes, such as remarriage, it is important to review your estate plan. Like many financial endeavors, estate planning often requires professional expertise. An estate planning team comprised of qualified tax, legal, and financial professionals may help ensure that your strategies meet your current needs and long-term objectives. $

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- **Extension of 100% exclusion on sales of small business stock through 2011.** Under the Small Business Jobs Act of 2010, investors are permitted to exclude 100% of the gain from the sale of certain small business stock acquired and held for more than five years, up from 75% previously, and the excluded gain is not subject to the AMT. To qualify, the stock must have been purchased before January 1, 2011. Under the 2010 Tax Relief Act, this 100% exclusion is extended for one more year to cover stock purchased before January 1, 2012.

- **Transit benefits extended one year.** Under the American Recovery and Reinvestment Act of 2009 (ARRA), the amount that may be excluded from the taxable income of employees used to pay for qualified mass transit, van pools, or parking was raised to $230 per month through 2010. This sum of $230 is equal to the tax-free benefit that employers may provide per employee, per month through a qualified transportation plan. Under the 2010 Tax Relief Act, these benefits are continued for one additional year, through December 31, 2011.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 offers a number of tax breaks for both individuals and businesses. However, many of the opportunities are temporary. For more information and advice about your unique circumstances, contact your qualified tax professional. $

Retirement Plan Assets and Multiple Taxation

Retirement planning generally focuses on providing finances to support your desired lifestyle after your departure from the workplace. At the same time, it is important to realize that, in all likelihood, your retirement savings may constitute a very large portion of your total assets. Upon your death, items such as your personal property and savings may ultimately be subject to varying degrees of estate taxation. Like all other assets, your retirement savings will generally be included. However, retirement plan assets will also be subject to *income* taxes in addition to *estate* taxes.

Should You Be Concerned?

Historically, high net worth individuals have been most concerned with estate taxation. However, if you have more than the applicable exclusion amount ($5 million in 2011), then Federal estate tax implications should be reviewed with competent counsel. With advance planning, you may be able to minimize your estate tax liabilities. Since your retirement plan assets are part of your estate, they may also be subject to estate taxation. In general, estate taxes are based on the full, *pre-income tax* value of the plan assets. In addition, income taxes will also be due on *pre-estate tax* values.

A distribution of the qualified plan or Individual Retirement Account (IRA) balance at an employee's or IRA owner's death can be income in respect of a decedent (IRD). Generally, IRD must be included in the gross income of the recipient beneficiary, although there is a deduction for estate and generation-skipping transfer (GST) taxes paid on the income. If the income is distributed over a number of years, only a proportional amount of the deduction is allowable each year.

Substantial retirement plan assets, especially those for which no advance planning has been made, may ultimately be subject to income and estate taxes at a combined marginal rate that could potentially approach, or even exceed, 70%. That translates into nearly three out of every four dollars of your retirement savings going toward paying taxes rather than funding your retirement or passing to your heirs.

Are There Any Alternatives?

Implementing a tax strategy geared toward passing retirement plan assets *in full* to heirs can be challenging, especially if you will depend primarily on your plan assets to meet your retirement income needs. However, those who are fortunate enough not to need the bulk of this income may consider taking all, or part, of the balance in a lump sum. Amounts not distributed may be directly transferred from the plan to an IRA. Even though substantial income taxes are due in the tax year of the withdrawal, the after-tax proceeds may be slowly gifted directly to your heirs free from additional taxation.

This gifting program can involve either *direct* transfers or transfers to an irrevocable trust established to benefit the heirs (gifts of $13,000 per individual or $26,000 for married couples in 2011, indexed annually for inflation, can be made annually without incurring a gift tax). This type of approach can help minimize, or possibly even eliminate, future estate tax liabilities.

It Pays to Plan

Saving for retirement requires hard work, foresight, and diligence. Once you have built your retirement assets, the challenge becomes asset preservation. With the assistance of qualified legal, tax, and financial professionals to review all the legal and tax consequences of your planning decisions, you may be able to enjoy your retirement while simultaneously passing on a sizable nest egg to your loved ones. $

Living Value: The Other Side of Life Insurance

Many people think of **life insurance**—in its simplest form—as a means of providing funds to cover financial obligations, such as a mortgage, or to replace income in the event of the death of a family breadwinner. It's no wonder that the **death benefit** under a life insurance policy is often its most well-understood feature.

However, not all policies are the same. A **permanent life insurance** policy contains a cash value feature that allows cash to accumulate, which may be used to help supplement a number of financial objectives, such as a retirement plan or a child's education. In this way, permanent life insurance has a "living value" in addition to the traditional **death benefit** feature. Let's take a closer look.

The Value of Cash Value

The cash value in this type of life insurance policy accumulates on a tax-deferred basis in the same way that money does in an Individual Retirement Account (IRA). Because of this tax-deferred accumulation, there may be some income taxes due upon withdrawal. However, you are generally only taxed on amounts that exceed the *total* amount of premium payments you've made over the course of the policy.

One of the key benefits of permanent life insurance is that you can access the accumulated cash values through policy loans. Generally, the loan interest rate is stated in the policy and is comparable to traditional lending rates. Bear in mind that access to cash values through borrowing or partial surrenders can reduce the policy's cash value and death benefit, can increase the chance that the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Another interesting aspect of a permanent life insurance policy is that, unlike a traditional IRA or another qualified plan, you may make premium payments after age 70½, and there are no rules that stipulate required withdrawals of cash values by age 70½. This feature may provide an opportunity to continue making premium payments and receiving the benefits of tax-deferred accumulation.

With a life insurance policy, there are few rules that limit the amount of premium payments. Simply stated, the higher the death benefit, the higher the premium will be. Some forms of permanent life insurance allow you to make premium payments in addition to what is stipulated under the terms of the policy. Paying additional premiums may increase the cash value. However, this may lead to adverse tax consequences. Generally, policies are written to avoid this possibility altogether. When considering an increase to your insurance coverage, be sure to discuss your options with your financial professional.

Dual Purpose Protection

Life insurance serves many purposes. Through its death benefit, life insurance aims to help protect and secure your family's future in the event of your death. At the same time, life insurance with a cash value feature may provide you with the opportunity to use the benefits of your policy during your lifetime. In this respect, life insurance can be a ready source of cash to help supplement an array of financial needs. A review of your current coverage with a qualified financial professional may help demonstrate how permanent life insurance can fit into *your* overall financial plans. $

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