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Make your estate more liquid with life insurance

If you're like many people, you may think that the sole purpose of life insurance is to help pay your funeral expenses and daily living expenses for your dependent heirs. But what you may not realize is that life insurance can be used to create liquidity so your heirs can pay your estate taxes.

Your estate may be composed primarily of illiquid assets such as closely held business interests, real estate or collectibles. These assets can be hard to sell; if your heirs need cash to pay estate taxes (or for their own support), they could face a cash flow problem. For that matter, you may not want these assets to be sold, as it may be preferable to keep them in the family.

Life insurance can provide your family the cash they need without having to sell such assets. Policy proceeds, which are exempt from income taxes, are generally available immediately upon the insured's death.

Second-to-die life insurance, which pays off when the surviving spouse dies, may make sense.

Life insurance basics

There are a variety of life insurance policy options available today, which can make the purchasing decision seem a bit overwhelming. But in a nutshell, they can be broken down into two basic types:

Term. This type of insurance generally isn't designed to support long-term estate planning goals, because it provides protection only for a specified time and becomes more difficult to obtain with increasing age. It may even be unavailable at age 65 and older.

Permanent. This type generally is designed to provide coverage beyond age 65, allowing it to effectively support long-term estate planning goals. Moreover, permanent insurance offers

the standard protection of a term insurance policy plus wealth accumulation benefits on a tax-deferred basis, which can also be used to offset the typically higher premiums.

Second-to-die policies may work best

Because a properly structured estate plan can defer all estate taxes on the first spouse's death, some families find they don't need any life insurance then. But significant estate taxes may be due on the second spouse's death.

In these situations, second-to-die life insurance, which pays off when the surviving spouse dies, may make the most sense. A second-to-die policy has other advantages over life insurance on a single life: Premiums are generally much lower than you'd pay for two individual policies, and uninsurable parties can be covered.

But a second-to-die policy might not fit into an existing irrevocable life insurance trust (ILIT — see "Seal your heirs' financial future with an ILIT" on page 3), which is probably designed for a single life policy. Make sure the proceeds

aren't taxed in either your estate or your spouse's by setting up a new ILIT as policy owner and beneficiary.

A big sigh of relief

The bigger your estate, the more important life insurance likely will be in your estate planning. Knowing that the proceeds will be there to help ensure your loved ones won't have to sell your hard-earned legacy, you can relax and let out a sigh of relief.

Seal your heirs' financial future with an ILIT

To avoid having substantial life insurance policy proceeds counted as part of your taxable estate, establish an irrevocable life insurance trust (ILIT). Treated as a separate legal entity, an ILIT is designated as both the policy owner and the beneficiary of the proceeds upon your death.

Generally, it's better to have the ILIT purchase a new insurance policy than to transfer an existing policy to the trust. You can gift cash — or other assets that the ILIT can then sell — to fund the purchase. If a health condition prevents you from purchasing a new policy, transferring an existing policy may be your only option. But if you die within three years of making a gift of life insurance, the policy's full value will be counted as part of your taxable estate.

A/R management

It's a common financial plumbing problem

In today's highly competitive economy, many companies are seeking to hang on to their cash and delay paying expenses until the last possible moment. Some are stretching the usual 30-day payment due period to 45 or even 60 days. As a result, businesses waiting to collect these payments may become financially strained, struggling to cover payroll and other essential operating expenses.

To stay afloat, cash-strapped companies may end up borrowing at costly interest rates, further jeopardizing their long-term financial health. A better solution is to strengthen accounts receivable (A/R) management.

Practical steps

Let's face it: No one likes to harass an overdue customer for payment. Collecting from clients in a timely manner while preserving your relationships with them is clearly a fine line to walk.

There are several practical steps you can take, however. Work with your CPA to implement billing and collections procedures, along with the necessary supporting business processes and systems. Your collections procedures should include:

- Background checks on all trade, bank and credit references for any new customers before agreeing to fill their orders,
- Realistic payment policies, including credit limits, required deposits, reimbursement for associated expenses, accepted and preferred methods of payment, due dates, and a process for resolving any payment issues,
- A phased payment schedule that requires, for example, payment in three equal parts based on a percentage of the estimated invoice amount,
- Reward/penalty clauses offering a discount for early payment and assessing a current fee — or a higher fee going forward — for late payments, and
- Timely follow-up so overdue payments don't slide beyond a couple of days.

Finally, don't underestimate the power of strengthening your relationships with customers through frequent personal communication and showing your appreciation for their business.

Simple gestures like these may increase their loyalty and desire to keep you happy.

From a trickle to a steady flow

If you don't feel comfortable confronting customers about late payments, delegate the collections responsibility to an administrative office manager or outsource it to a third party. But, reserve costly collection agencies and legal actions as absolute last resorts. You'll likely find greater success in simply requesting return of a shipment, settling on trading products or services, asking for a promissory note or getting a third party to arbitrate a settlement.

In short, more practical and effective A/R management combines the essential elements of planning, diplomacy and diligence.

The state of estate planning

Rumors of the death of estate planning have been greatly exaggerated. True, the 2001 tax law repealed the federal estate tax. But under current law, the repeal is effective for only one year — 2010. Absent further legislation, the estate tax will be brought back to life in 2011 — at 2001 levels. (See "Transfer tax exemptions and rates" on page 5.)

Most experts expect lawmakers to pass new estate tax legislation before 2010, but it's not certain what they'll do. Many believe that Congress will repeal the repeal and preserve the estate tax with a higher exemption amount (between $3 million and $5 million, for example). Whatever Congress does, it may have a significant impact on your estate plan.

Shift of focus

Historically, estate planning has focused on avoiding or minimizing federal gift and estate taxes. Many estate planning strategies have, as a byproduct, negative income tax consequences (such as the loss of a stepped-up tax basis, discussed below) but, in most cases, the income tax *cost* is overshadowed by the gift and estate tax *savings*.

As gift and estate tax rates drop and the estate tax exemption climbs, however, fewer people are subject to estate taxes and, for those who are, the potential liability is less. So, the income tax implications are becoming more significant.

As gift and estate tax rates drop and the estate tax exemption climbs, income tax implications are becoming more significant.

Consider the intentionally defective trust. An *income* defective trust can be an effective vehicle for shielding wealth from estate taxes. Your initial contribution is a taxable gift, but the trust

assets — including any future appreciation — are removed from your estate. By reserving certain powers over the trust, however, you can render it defective for income tax purposes. That means you'll pay the taxes on any trust income.

Why is that a good thing? Because otherwise, the *trust* would be liable for the taxes, eroding the amount of wealth available to your beneficiaries. By paying the tax, you preserve the trust assets for your heirs, essentially making an additional tax-free gift.

One disadvantage of an income defective trust is that trust assets don't receive a stepped-up tax basis. Normally, when you transfer assets at death, the tax basis is stepped up to the assets' fair market value at that time. This means your heirs can turn around and sell the assets immediately without recognizing any capital gain. But when assets are transferred in trust, they don't receive a stepped-up basis. So it's likely your beneficiaries will be subject to capital gains taxes if they sell the assets.

If you have a large taxable estate, this probably isn't a big problem because the potential income tax consequences likely are outweighed by the estate tax savings. But if you expect your estate to fall within exemption limits, a different strategy may be called for.

Transfer tax exemptions and rates

Year	Estate and GST tax exemptions[1]	Gift tax exemption	Highest estate, GST and gift tax rate
2007	$2 million	$1 million	45%
2008	$2 million	$1 million	45%
2009	$3.5 million	$1 million	45%
2010	(repealed)	$1 million	35%[3]
2011	$1 million[2]	$1 million	55%[4]

[1] *Less any gift tax and generation-skipping transfer (GST) tax exemptions used during life.*

[2] *The GST tax exemption is adjusted for inflation.*

[3] *Gift tax only. Equal to highest marginal income tax rate, which is currently 35%.*

[4] *Reverts to 2001 rules. The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates and gifts over $10 million.*

Source: *U.S. Internal Revenue Code*

Income tax tactics

When estate tax savings are less of a concern, *estate* defective trusts gain appeal. This type of trust is essentially the opposite of an income defective trust. It shifts the income tax burden to your heirs while retaining the assets in your estate.

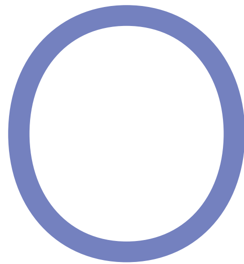
As long as your estate is within the exemption amount, an estate defective trust won't generate any estate tax liability. But if your beneficiaries are in a lower tax bracket (your children, for example), the trust will help ease your family's overall income tax burden. And by keeping the assets in your estate so they're transferred at death, your beneficiaries will enjoy the income tax advantages of a stepped-up basis. Note, however, that the 2001 tax law places limits on the assets entitled to a stepped-up basis during the 2010 estate tax repeal.

Review your plan

The need for estate planning will continue, regardless of what happens to the estate tax. The question as to whether your planning should focus on minimizing estate taxes or minimizing income taxes is only one example. In the coming years, be sure you and your tax advisor review your plan regularly and adjust it, if necessary, in light of any legislative developments.

Like-kind exchanges at a glance

Deferring taxes by swapping real estate

ne advantage of investing in real estate is that its value can grow for years without triggering current income taxes: You're not taxed on the gain until you decide to dispose of the property. This advantage can become an obstacle, though, if it causes you to hang on to real estate longer than you should, just to avoid a tax hit.

You may be able to have your cake and eat it too by swapping the property for another one that better suits your needs. A like-kind exchange — also known as a Section 1031 exchange — allows you to trade one property for another without recognizing current capital gains.

Meeting the requirements

Despite the term "like-kind exchange," to meet the Sec. 1031 requirements you simply need to swap one property used in a business or held for investment for another property that you also intend to use for business or investment purposes. Other than that, the two properties need not be similar. So, for example, you could exchange a shopping center in New Jersey for a rental apartment building in Hawaii.

It is, however, important that the *values* of the exchanged properties be comparable. Any cash you receive in the transaction must be recognized as taxable gain. Also, it's a good idea to use the property for business or investment purposes for a reasonable amount of time. To qualify for a like-kind exchange, it's only necessary that you *intend* to use the property in that way. But a reasonable amount of actual business or investment use (two years is a common rule of thumb) can help you avoid an IRS challenge.

If you swap properties with a related party — such as a family member or another business that you control — both properties *must* be used for business or investment purposes during a two-year holding period. If either party disposes of their property within that time, the like-kind exchange becomes taxable.

Timing it right

Sec. 1031 was originally designed to apply to simultaneous exchanges, but, in the real world, there are few opportunities to simply trade deeds with someone. To provide greater flexibility, the law has evolved to allow "deferred exchanges" in which you sell (or relinquish) property to one party and then acquire replacement property from another.

To qualify for tax deferral, you must identify up to three potential replacement properties within 45 days after you sell the property you're relinquishing and complete the transaction within 180 days after the sale. Also, you must never gain control over the sale proceeds. Instead, you must engage a "qualified intermediary" to sell the property, hold the proceeds and then use them to purchase replacement property.

Looking for parking

What if you come across an ideal replacement property, but you need to move quickly to acquire it? A *reverse* exchange allows you to purchase the replacement property first and then sell one or more relinquished properties later.

Reverse exchanges are a bit more complicated than forward exchanges. The IRS has issued safe-harbor guidelines for structuring a reverse exchange that meets the requirements of

Sec. 1031. Among other things, the guidelines require you to "park" the replacement property with a special type of intermediary — an Exchange Accommodation Titleholder (EAT) — until the exchange is complete. You'll also need to identify one or more properties to relinquish within 45 days after the EAT receives the replacement property and complete the transaction within 180 days.

Inviting opportunity

Like-kind exchanges provide an excellent opportunity to meet your property needs or diversify your real estate investments without taking a tax hit. Structuring an exchange — particularly a reverse exchange — can be complicated, so be sure to consult your tax advisor to avoid costly mistakes.

How your business can make the most of the manufacturers' deduction

The 2004 tax law created a new income tax deduction for domestic production activities. Manufacturers, construction firms, architects, engineers, software developers, agricultural processors and others can now deduct 6% of their net income from qualified activities (9% starting in 2010) or, if less, 6% (also 9% starting in 2010) of their taxable income for the year (without regard to the deduction).

Qualified income is generally calculated by taking gross receipts from qualified domestic production activities and subtracting the costs of goods sold and certain other costs. Typically, this income is derived from manufacturing, producing, growing or extracting property "in significant part" within the United States. Domestic construction projects, audio and film production, and certain other activities also qualify.

If your business is eligible for the manufacturers' deduction, now is a good time to review your financial picture to identify opportunities to maximize the benefits. Here are a few places to look:

Wages. The deduction is limited to 50% of your W-2 wages for the year. Legislation passed last year clarifies that this limitation includes only wages attributable to qualified production activities. It may be possible to increase your deduction by shifting some work from contractors to employees or by increasing owners' salaries.

Costs. Regulations finalized in 2006 establish a safe harbor for meeting the "in significant part" test described above: Property is deemed to have been produced in significant part within the United States if at least 20% of the cost of goods sold is attributable to U.S. labor and overhead costs. You may have an opportunity to shift some costs into the United States to ensure that you meet this threshold. Special rules apply to construction projects and to property that is leased rather than sold.

Income. As noted above, the deduction is limited to a percentage of your income from qualifying activities or, if less, a percentage of your taxable income. In other words, if you have no taxable income for the year, you can't benefit from the deduction. In addition, the manufacturers' deduction generally can't be used to create or increase a net operating loss deduction. If you have little or no taxable income, consider accelerating some income into the current year to take advantage of the deduction.

These are just a few ideas for making the most of the manufacturers' deduction. Whether they'll work for you depends on the nature of your business, its structure and your specific financial situation. The law and regulations are quite complex, so be sure to consult your tax advisor to devise a strategy that's right for your business.

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