

COMMUNITY BANKING & PERSONAL FINANCE

Time To Take Advantage Of Estate, Business Benefits

CLIENTS COULD BE HIT WITH STEEPER TAX BILL IF RATES RISE NEXT YEAR

By VINCENT A. LIBERTI

What tax loopholes should our wealthier clients take advantage of the next two years thanks to the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act (2010 Act) signed into law Dec. 17, 2010? If they simply wait until the end of next year, unprecedented estate and business benefits may be lost only to be replaced by steeper estate and gift taxes.

So, what should they do now before being confronted by higher taxes? In short, they should consider shifting wealth to their heirs. Yes, gift certain assets to take advantage of the two-year tax loopholes of this 2010 Act. The most advantageous areas of gifting are now with real estate, business assets and whole, universal and variable life insurance policies with high cash values.

Real Estate

Prior to the 2010 Act you could not gift more than \$1 million during your lifetime. Pursuant to present law, the gift exemption returns to \$1 million again in year 2013 and there may be much political and economic pressure to keep the gift exemption at that \$1 million level.

But, for this and next year that figure has jumped to \$5 million. At the same time, values of real estate and family-owned businesses are now at or near all-time lows. What does this mean — in plain language? It means that for this year and next year only, clients can put more of their residential, non-rental real estate (second homes) into trusts (called QPRTs) while the real estate values are low and the gifting threshold is high.

Properly drafted, the transfer will not diminish their use of the home transferred to the trust. The reason to make the transfer into a trust is to eliminate its present value — and appreciation — from their estate to avoid estate taxes. This move could avoid likely estate taxes of anywhere from 35 percent to 60 percent, depending upon the estate tax rates Congress will likely alter at the end of next year. If Congress does nothing, the estate and gift tax rates will increase up to 55 percent (with an added 5 percent to the estate tax rate for estate values over \$10,000,000).

Businesses

Likewise, it is a perfect time for clients to finally make the move to form and implement a thorough review of their business's succession plan and to gift closely-held business interests

to the next generation(s) of family members. Values are low, interest rates that determine the "gift" amount of the transferred interest are low and the gift threshold is temporarily high. Thus, they now can transfer more business interests, and thus more taxable wealth, to other family members to avoid estate taxes. Properly drafted, the transfer will not diminish their control over the business.

Besides gifting business interests to family members, the review of their business plan should include a look at buy-sell provisions and their valuation formulas in case of their or a co-owner's departure from the business, either voluntarily, by death or disability. It is also a good opportunity to integrate business assets into their estate plan using family generational (or dynasty) trusts.

Recently, President Barack Obama has indicated his desire to cap the term of any dynasty trust to 90 years. Before Congress imposes a cap in a dynasty trust's term and while the gift threshold is temporarily high, clients may put more assets into such trusts for the benefit of their descendants and simultaneously further reduce their taxable estate. In addition, the trusts will provide asset protection for their descendants, and depending upon the jurisdiction of the trust, the client too.

Remember, business entities must adhere to the statutory mandates of operating a business — proper records, timely meetings and their minutes, etc. All of these matters should be reviewed as part of an estate and business review with the goal to lower taxes, provide a smooth transition of management/ownership and protect assets.

Consider a couple, both age 65, with a taxable estate. They own their own business and a second home in Florida worth \$1 million. Presently, they each own 50 percent of their business estimated to be valued at \$5 million. They have two adult children. How can they avoid or limit estate taxes?

Real Estate Example

1) A February, 2011 transfer of the \$1 million Florida home into a trust (QPRT) yields the following:

- Value of gift, which is subtracted from the \$5 million gift threshold \$241,320
- Value that passes outside of their estate with no gift tax consequences: \$758,680
- Appreciation also avoiding estate taxes assuming a 5 percent growth over 20 years: \$1,653,298
- Tax savings — assuming death at age 85 (after 20 years) and a 35 percent estate tax: \$844,192



Vincent A. Liberti

- Tax savings — assuming death at age 85 (after 20 years) and a 55 percent estate tax: \$1,326,588

Gift Of Business Example

2) They could also shift some of their business interest to their children.

A gift of 10 percent of the business stock to each child would be worth \$500,000 each. However, under present law, one could apply a discount to that value for lack of marketability by about 25 percent, and lack of control for another 25 percent, thus reducing the taxable value of the gift further to \$250,000 to each child. This gifted value is removed from the parents' gross taxable estate upon death.

Remember, this includes 10 percent of the appreciated value of the business over the next 20 years too. Also, consider that Congress now must have revenue offsets with every enacted tax savings provision, so discounts for lack of marketability and lack of control — perceived "loopholes" — may become old law come the end of next year.

People who have had their estate and business estate planning intentions limited by the previous \$1 million gift tax exemption, definitely should consult their estate planning attorney to consider gifting this and next year before these benefits become lost opportunities. People with real estate, business interests and multi-generational gifting desires will benefit the most.

Life Insurance Trusts

After the Indiana appeals court decision *In Re Stuart Cochran Irrevocable Trust*, trustees of a life insurance trust (ILIT) have clear notice of their fiduciary responsibilities in managing trust assets even if it is only the life insurance policy on the maker's life. After this first-of-its-kind case, trust beneficiaries may now be able to sue trustees for failing to employ a "prudent process" in managing the trust assets.

Too many of us do not consider our life insurance policy after purchasing it. However, life insurance is an asset class like any other in a client's portfolio that needs to be reviewed and monitored. Substantial premiums may be preserved as a result.

Having policies reviewed by an outside, independent entity, that has no financial stake in the review process may be the best means to prevent a court decision that a trustee did not fully and adequately manage and protect trust assets. A trustee's duty to manage trust assets includes determining if an existing life insurance policy should be exchanged for a new policy that minimizes costs and maximizes benefits.

For example, one of our clients recently engaged a life insurance advisory firm that does not make in-house determinations of suitability (as often is the case with many agents/brokers), but instead buys independent pricing and performance research reports from their insuranceadvisor.com. One of the holdings in this client's portfolio was a \$30,000,000 policy from an A++ rated insurer. We asked local agents of this advisory firm, Steven Zeiger and David Buckwald, who both subscribe to a "prudent process" that includes suitability determinations from this outside, independent entity and

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When Completing Returns, Pay Attention To Changes

CONGRESSIONAL ACTION MEANS LOWER TAXES,
HIGHER DEDUCTIONS FOR MANY

By MARY HOYT

With less than a month left until Tax Day arrives, there are a number of significant changes to state and federal tax laws of which people should be aware. Knowledge of these important changes could prove beneficial as state residents prepare their 2010 tax returns.

These changes include the following, each of which is discussed in-depth within this article:

- Filing deadline of April 18th
- Tax rates for individuals will remain at their 2010 levels
- Personal exemptions and itemized deductions no longer phased out
- Tax credit for educators extended
- Homeowners energy credit extended
- American Opportunity Tax Credit extended

First and foremost, individuals should be aware of the filing deadline for state and federal tax returns — Monday, April 18 of this year. This is due to the fact that Washington, D.C., will celebrate Emancipation Day on Friday, April 15, and, as a result, tax returns filed by the April 18 deadline will be considered timely filings. The extra three days could prove to be helpful to many filers.

Perhaps the most important piece of information for people to know is an item that dominated news coverage around the holiday season — the enactment in December of the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.” This tax cut package extended the 2010 personal income tax rates for all filers for the next two years, rather than reverting to scheduled higher rates per the 2001 act.

The capital gain and qualified dividend tax rates will not increase through 2012, either. This will mean tax savings for individuals this year that had not been anticipated, which indeed could come as welcome news for them.

Another major benefit this year comes in the area of itemized deductions and personal exemptions. Starting in 2010, these items are no longer being phased out. This will continue in 2011 and 2012. The personal exemption amount for 2010 is \$3,650, and the inflation-adjusted rate for 2011 is expected to rise to \$3,700.

There is more good news with the extension

of a number of tax credits for the coming year, including a tax credit of up to \$250 for teachers who spend their own money on classroom expenses. Additionally, the Residential Energy Property Credit has been extended through 2011,

although at a lower level. This credit, for home energy conservation upgrades, will reduce from \$1,500 in 2010 to \$500 in 2011.

Finally, the American Opportunity Tax Credit (a temporary replacement of the HOPE education credit) has been extended for two more years through 2012. This is a higher education tax credit that can be claimed for all four years of post-secondary education, whereas the old HOPE credit was only available for the first two years of post-secondary education. A portion of this credit is refundable. Even if you owe no tax, eligible tax payers could receive a refund of up to \$1,000.

The income limitations on this credit have also been extended, with a phase-out that begins at \$80,000 of Adjusted Gross Income (AGI) for singles and \$160,000 for married couples filing jointly, and ends at a modified AGI of \$90,000 for singles and \$180,000 for married couples.

These extended credits and benefits could indeed prove beneficial for individuals during this year’s upcoming tax season, and filers should certainly inquire about them when preparing their 2010 returns. ■

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who had no financial stake in the review process, to help our client understand these pricing and performance research reports.

Based on the independent research from theirinsurancadvisor.com, the agents helped our client understand for the first time what he was actually being charged relative to both industry average pricing and best-available rates and terms. Because the original selling agent who placed this policy provided the client with only an illustration of hypothetical policy performance, thus a comingling of actual policy charges and assumed investment performance, the client was oblivious to being overcharged by almost 40 percent.

As a result of this review, our client not only understood the true costs of his old policy but learned that he could exchange his old policy for

a new one with either \$12 million of additional coverage for the same premium, or reduce his premium by over \$100,000 for the same coverage.

With mortality tables and interest rates recently modified and the message of Cochran, it is critical for our clients to have their life insurance policies reviewed to compare their existing policies and their costs, with like policies and their costs across the entire industry. The tax advantages discussed in this article are probable targets for congressional change/elimination, which Congress does not have to wait until the end of next year to implement. Even without congressional action, the gift and estate tax exemptions automatically decrease back to \$1 million in the year 2013. Thus the prudent course is to advise clients to take action now to investigate estate and business options that may soon disappear. ■

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COMMUNITY BANKING & PERSONAL FINANCE

Positive News For Small Business Borrowers

FEDERAL RULES RELAX REFINANCING STANDARDS FOR REAL ESTATE LOANS

By **ROBERT POLITO JR.**

Recent changes to the Small Business Administration's 504 loan program now temporarily allow for conventional owner-occupied commercial real estate loans to be refinanced. This change is unprecedented in the program's history.

It is the SBA's hope this change could significantly assist small business owners who have

commercial real estate loans maturing in the near future. Many borrowers, who have remained current as to their loan payments but have seen their business decline during the recession, may not see their loans approved for renewal. The same is true based on the decline in asset values of their real estate. Combine the decline in business operations and the lower asset values of commercial real estate, and the resulting news from their

bank may not be very positive.

Under existing SBA 504 rules, the loan program allows financing for the acquisition of real estate and equipment. The SBA 504's temporary change allows for the refinance of commercial real estate debt and any other debt acquired in support of the commercial real estate project. This could include machinery and equipment purchased and leasehold improvements in sup-

port of the business operations.

The SBA can also include other debt, up to 15 percent of the total refinance, under certain conditions. The SBA will also allow the re-amortization of the original debt. The ensuing loan based on the refinancing, to include other projects costs and re-amortization, could significantly lower the required debt service to the business owner. The debt service savings could free up resources for the business to hire new employees, purchase inventory, or to just simply reduce overhead expenses.

The time to act is now. The temporary changes allow for the refinance for loans that will mature or balloon by Dec. 31, 2012. Applications are required to be approved by the SBA by the end of September 2012.

Worry-Free Capital

Many bankers favor broadening the recent changes to include all owner-occupied commercial real estate borrowers regardless of when their loan matures. Deleting the requirement of a maturity of Dec. 31, 2012 would greatly expand the population of those businesses that could be helped. With present federal budgetary constraints and the timing of those in need in the short term, the changes are certainly welcome, but a long term fix is needed.

Broadening the requirements could fill the gap for business owners for many years in the future. A worry-free capital structure would allow businesses to focus on their business operations and not on their debt and their bank.

Additional SBA 504 requirements for the refinance include: 1) a 90 percent loan-to-value (a very liberal lending requirement) or a minimum of 10 percent equity, 2) current on debt payments during the previous year and 3) a bank-ordered new appraisal. Borrowers are advised to work with a bank having extensive SBA-related experience and knowledge of the process.

With the SBA recently increasing its lending limit for the SBA's share to be as high as \$5.5 million, coupled with the bank's participation, this program satisfies most businesses' needs now and well into the future. The SBA estimates 20,000 businesses could be eligible to receive assistance with \$15 billion in financing, rising as high as \$30 million with leverage by the banks.

Clearly, the SBA is attempting to fill a gap in the near term for borrowers with the most need. Demand is difficult to predict. Time will tell on the change's impact. As a zero-subsidy program, taxpayer dollars do not support this initiative and it therefore could be regarded as a win for the taxpayer. At the same time, it enables the business owner to improve his or her capital structure, and the bank to assist in job creation and financing our economic recovery. ■

Robert Polito Jr. is the director of Government Guaranteed Lending at Webster Bank.

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