Tick tock, tick tock

Time can be your friend or your foe when it comes to financial independence

Time never stops. And neither should your efforts to build and protect your — and your family's — financial independence. Engaging in smart tax planning strategies now will go a long way toward ensuring a financially secure future for you and your loved ones. But, as each year passes without you having a comprehensive plan that covers estate planning and asset protection, you'll have less time to grow and safeguard your wealth. There are many ways you can get started — and keep going.

Consider transfer tax exemptions and rates. During your lifetime or at death, you can transfer up to the exemption amount ($1 million during life and whatever is left of that $1 million plus an additional $1 million at death) free of federal gift and estate taxes. If your taxable estate is equal to or less than the remaining exemption, no federal estate tax will be due when you die. But if your estate exceeds this amount, it will be subject to estate tax. With the gradual phaseout of the estate tax and then its scheduled return in 2011 (see Chart 6), gift and estate planning is especially important.

Make lifetime gifts. Gifts you make during your lifetime are subject to federal gift tax. Fortunately, you can exclude most gifts of up to $12,000 per recipient each year ($24,000 per recipient if your spouse elects to split the gift with you) without using up any of your lifetime exemption. To use the annual exclusion, you must give recipients a "present interest" in the property. In other words, the recipient generally must have current access to the funds. If you want to retain more control, consider a Crummey trust, where, because of a temporary withdrawal right, the gift will qualify for the annual exclusion — even though the recipient doesn't have access to the gifted assets after the withdrawal right expires.

You may also pay eligible educational and medical expenses for a loved one without the payment being treated as a taxable gift, so long as the payment is made directly to the provider.

Determine which property to gift. Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. To minimize *estate* taxes, gift property with the greatest future appreciation potential. To minimize *income* taxes, gift property that hasn't already appreciated significantly since you've owned it. That's because your basis in the property generally carries over to the recipient,

Chart 6

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 GST tax exemptions, respectively, 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

Tax Action Strategy

Evaluate insurance needs

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to succeeding generations free of estate tax. Long-term disability insurance is also important. For many, future earning power is their biggest asset, and employer-provided coverage is often insufficient. Long-term care insurance also is worth considering, because savings can disappear fast if you or a loved one requires years of such care.

who will owe taxes on any gain when he or she sells it. While the estate tax is in effect, it may make sense to wait to transfer highly appreciated assets until your death, because the basis will be stepped up and the capital gains tax can be avoided. For property that has declined in value, your best bet is to sell the property to take advantage of the tax loss. You may then gift the sale proceeds.

Take advantage of the unlimited marital deduction. Your estate generally can deduct the value of all assets that pass in a qualified manner — either outright or in trust — from you to your spouse at your death, provided your spouse is a U.S. citizen. (If your spouse isn't a U.S. citizen, you can still take advantage of the unlimited marital deduction, but you must use a qualified domestic trust, or QDOT.) But if your combined estates are greater than the exemption amount, simply using the full marital deduction to avoid taxes on the first spouse's death could result in needless tax liability on the surviving spouse's death. A credit shelter trust can help minimize the estate tax by taking advantage of both spouses' exemptions.

Keep an eye on the GST tax. The generation-skipping transfer (GST) tax was designed to limit an individual's ability to transfer wealth to successive generations without incurring a gift or estate tax at each generation. It is now, and scheduled to remain, equal to the top estate tax rate, and the GST tax exemption is also equal to the estate tax exemption. (See Chart 6 on page 15.) You can make the most of this exemption by setting up a GST or dynasty trust. And you can preserve your GST tax exemption for future transfers by making annual exclusion gifts to grandchildren or more distant generations. Such gifts generally are exempt from the GST tax.

Set up trusts to preserve assets and control. Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. They serve a variety of purposes. For example, a qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage. An irrevocable life insurance trust (ILIT) can keep insurance proceeds out of your and your spouse's taxable estates. A qualified personal residence trust (QPRT) allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax value (provided you survive the trust's term) — while you retain the right to live in it for the trust's term. A grantor-retained annuity trust (GRAT) works similarly for other investments, except instead of retaining the right to live in your home over the trust's term, you receive payments from the trust for a specified period.

Plan for family business interests. If you're a family business owner, transferring business ownership can preserve your business and accumulated wealth — if planned properly. For instance, consider tax breaks such as the family business estate tax deferral and valuation discounts. And protect yourself with a well-structured buy-sell agreement. Gifting family business stock also can be an effective estate-tax-saving strategy. But keep in mind that the gift's value determines the gift and estate tax ramifications. And the IRS may challenge the value you place on a gift. A valuation by a professional appraiser can help the value stand up to such scrutiny.

Split up assets carefully in a divorce. Divorce is never easy, and it becomes even more difficult when marital property is significant. Talk with your advisors about how to handle the taxes, "innocent spouse" tax law provisions, and qualified domestic relations orders (QDROs) for retirement funds and property transfers. Discussing these items thoroughly will help you make the best of a bad situation.

Protect assets. In our litigious society, asset protection planning is more important than ever. Ask your financial professional about strategies such as transferring assets to your spouse; family limited partnerships; liability insurance; Delaware, Alaska or offshore trusts; and even your retirement plan. ◆