

Personal Financial Services

2010 Guide to tax and wealth management

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Tax planning and wealth management can be intimidating processes in any economic environment, but especially so now, given the events of the past year.

After the collapse of Lehman Brothers in September 2008, credit markets froze, causing severe dislocations in money markets and unprecedented high levels of anticipated market volatility. Fearing further losses, investors fled the stock market in favor of safer investments. At the same time, falling property values eroded net worth and capital and stalled consumer spending amid continued tightness in the consumer credit market.

After the initial crisis and a period of steep decline, however, the speed of the economic downturn has slowed. Global trade and manufacturing have stabilized, and industrial production is declining at a slower rate. In the financial system, a number of critical difficulties have been repaired, but other questions—from tangibles, like monetary policies, to intangibles, like trust and confidence—remain. The stock markets have staged a partial recovery, but

even though the world economy shows signs of improvement, the challenges remain vast.

The question is, How does, and should, this new economic landscape impact your wealth management plan?

Now is the time to review and reevaluate your approach. Tax planning and wealth management are undertakings that should be actively overseen throughout the year, but year's end—and the approaching tax deadline it heralds—is a logical time to step back and take a fresh look at both your goals and the ways you plan to reach them. This year, perhaps more than any in recent memory, calls for such a review.

Certainly, much has changed, and the economic landscape continues to evolve. And the Obama Administration is expected to effect further changes—likely, increases—in the tax environment. But opportunity is inherent in times of change. Within that context, you may want to reconsider your short-term goals—given the realities of the current environment—while adjusting your long-term goals. In this period of transition, though, it's useful to remember that tax planning and wealth management are still about what they've always been about: navigating complexity for long-term success.

There's plenty of complexity in the tax system, and managing taxes is an important piece of the puzzle. But long-term success in wealth management is about much more than tax management only. It's also about control. And that control can be achieved through an understanding of wealth management strategies and tools and the ways to apply them strategically—and uniquely—to each individual's situation.

To that end, we've restructured our annual guide to focus broadly on the wealth management strategies and tools that are most instrumental to building an effective plan. Those strategies and tools are explored in the following chapters:

- / Strategic tax planning
- / Managing your portfolio
- / Charitable giving
- / Estate and gift planning
- / Business succession planning
- / Choosing entities for businesses/investments
- / Family limited partnerships
- / Insurance
- / Family offices
- / Working with financial advisers

The chapters examine the key elements, tax implications, concerns, and special considerations involved in each strategic area of successful wealth management planning. Additional information on these topics can also be found on our Web site pwc.com/pfs.

Our goal is to describe the pertinent concepts and strategies so that you understand and familiarize yourself with them and can then discuss them knowledgeably with your adviser. This will enable you to work together to develop a financial plan that is right for you and to protect, grow, and steward your personal wealth into the future generations of your family.

Sincerely,



Richard Kohan
US Leader, Personal Financial Services

The PricewaterhouseCoopers Personal Financial Services practice comprises a national network of experienced personal tax and financial advisors who help high-net-worth individuals effectively preserve and enhance their wealth. Our professionals provide a wide range of independent financial planning advice, including family office services, personal investment advisory services, wealth transfer solutions, business succession planning, personal tax services, charitable planning, lifestyle planning, and executive and employee financial program services. For more information about our personal financial services, please visit pwc.com/pfs.

PricewaterhouseCoopers provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.



04 / Strategic tax planning

Proactive tax planning is a central component of wealth management. Especially in the current environment of rising tax rates, a well-thought-out, strategic tax plan enables you to prepare for upcoming tax expenses and to apply the tools and strategies that will best position you at tax time.



16 / Managing your portfolio

Amid continued economic uncertainty and rising tax rates, it's critical to understand the basics of investment planning, investor behavior, asset location, and documentation of investment decisions. These fundamental principles form the foundation upon which successful individual investment and wealth management plans are built.



24 / Charitable giving

Private philanthropy has long been an important element of long-term wealth management plans. When building a charitable giving plan, it's important to consider the advantages, disadvantages, and tax considerations of the various charitable structures available and to select the ones that will best serve your philanthropic goals.



34 / Estate and gift planning

Wealth transfer planning enables you to protect your wealth and steward it into future generations. Although each individual's situation is unique, it is almost always appropriate to follow a four-step process in building an effective estate plan.



44 / Business succession planning

A well-thought-out plan for business succession is a key component of overall business success. However, this process is often overlooked or mishandled. Following 10 key best practices increases the chances of success—both of the transition itself and of the business in the long term.



52 / Choosing entities for businesses/investments

Businesses and investments typically take one of five common entity forms, each of which has a different impact on a wide range of considerations, including taxes, liability protection, and financing and estate-planning options. Choice of entity is an important decision, which should be made carefully and be periodically reevaluated as conditions change.



58 / Family limited partnerships

A family partnership is a separate business entity established to manage a family's assets and investments. The family partnership can be an excellent way to control, grow, and transfer wealth to future generations while taking advantage of sophisticated investment attributes available to large investment pools.



68 / Insurance

Insurance is a critical tool in preserving both your health and your wealth, and being properly insured is a fundamental part of a sound wealth-management strategy. Insurance should be considered in several areas, including medical and disability, property and casualty, life, and liability.



80 / Family offices

Family offices can provide a wide variety of services for high-net-worth families, from tax and estate planning to concierge and other personal services. While the precise structure and function of a family office are tailored to the needs of each individual family, the mission is nearly always the same: to manage and protect the best financial interests of the family in both the short and long terms.



86 / Working with financial advisers

Much like running a business, personal wealth management is best approached with the counsel of trusted advisers. Working with a team of financial advisers assembled to suit your specific needs enables you to take a controlled and strategic approach to your own unique wealth management goals.

Strategic tax planning

Proactive tax planning is a central component of wealth management. Especially in the current environment of rising tax rates, a well-thought-out, strategic tax plan enables you to prepare for upcoming tax expenses and to apply the tools and strategies that will best position you at tax time.



Having an overall plan for your taxes provides a number of benefits—namely, the knowledge that you’re taking control of your wealth and exercising the necessary discipline over this aspect of your financial plan. With marginal tax rates currently at 35%, taxes often represent the largest single cash flow expense for high-income taxpayers. Such a large budget item deserves attention and proper planning. Planning ahead ensures that you will be prepared for upcoming tax expenses and will be able to implement strategies and ideas that best situate your wealth and assets at tax time.

Tax planning is especially important for high-net-worth individuals in the current environment of rising tax rates. Rates enacted under the Bush Administration will expire in 2011, bringing about increases in tax rates for ordinary income, capital gains, and dividends—and no congressional action is needed for those increases to take place. In addition, there are proposed changes currently before the legislature that could alter the tax landscape as Congress faces increased pressure to find ways of increasing tax revenues and shrinking the federal deficit.

Where do I start?

While each plan will be unique based on individual goals and the appropriate strategies for reaching those goals, a typical starting point is to do a tax projection (capturing all expected income, deductions, and credits). It is best to look at your expected tax liability not just for 2009 but also over the next couple of years. Other important data points to gather in anticipation of tax planning include an up-to-date balance sheet (showing cost and fair market values of assets) and a summary of any tax carryovers to the current year (e.g., capital losses, net operating losses, investment interest expense, and charitable contributions). Then, use that framework as a guide for the specific planning components that should be considered to help you reach your goals in a more-tax-efficient manner.

Another important suggestion in the creation and maintenance of a tax plan is to keep track of deductions as they occur. Trying to reconstruct documentation of legitimate expenses at the tax deadline is time-consuming and burdensome and may result in overlooking available deductions. Software such as Microsoft's *Money* or Intuit's *Quicken* can greatly help in tracking income and deductions if you have the self-discipline to keep the file up-to-date on a regular basis.

Three fundamental planning techniques

A successful tax plan is an intricate effort, with three basic techniques used for approaching an individual's specific needs: accelerating or deferring income, shifting income to other family members or family-controlled entities, and converting income from something taxed at a higher rate to something taxed at a more favorable rate.

Accelerating or deferring income

Almost all individuals report their income and deductions by using the cash method of accounting—that is, income is reported in the year it is actually or constructively received, and expenses are deducted in the year they are paid—which can provide

quite a bit of flexibility in implementing acceleration or deferral strategies. When conditions point to higher tax rates in future years, most of the time it makes sense to accelerate income into earlier years, so the income is taxed at the current, lower rates. The timing of certain types of income such as salary or dividends cannot be easily manipulated. However, other types of income lend themselves readily to acceleration. For example, taxpayers have great latitude regarding when to recognize a capital gain. Taxpayers may also be able to accelerate receipt of installment sale payments or may be able to liquidate a fixed-income security to trigger the taxation of accrued but unpaid interest income.

Likewise, in an environment where rates are rising, it would generally make sense to defer losses and deductions to later years when those losses and deductions might offset income that is taxed at a higher rate. For example, a taxpayer might choose to hold off on making a large charitable contribution at year-end in 2010, instead making the contribution in January 2011 if tax rates are higher in 2011.

Changing the timing of the recognition of income or deductions from one year to the next can be a very effective tax-planning strategy—especially for those in high-tax-rate brackets, because they will save the most. Of course, the time value of money must be considered in connection with that strategy, since you will be paying taxes sooner than you otherwise would have paid them. Additionally, you must look at your individual circumstances. Tax rates will not increase in 2011 for all taxpayers, and the income and deferral strategy may not work well in those situations. Taxpayers whose incomes are under \$250,000 are not expected to see an increase in tax rates. Likewise, taxpayers who retire in 2010 may have less income in 2011 and therefore may be in a lower tax bracket in future years.

Global family perspective

Another effective way to address your tax plan is to view it not with the aim of reducing taxes on a particular return but with the aim of planning for the overall reduction of taxes for your family (or a group of entities) as a whole. Taking a global family perspective in your tax plan encourages you to consider shifting income to those taxpayers (children, businesses, trusts) who may fall under a more advantageous tax rate. It also allows planning for lower-income family members who may be able to take advantage of tax breaks not applicable to family members at higher income levels—for example, first-time-home-buyer credit, Roth IRA (individual retirement account) contributions, and tuition deductions.

The key to successful global family planning lies in deciding what income or assets can be shifted, what is the most effective strategy to bring about the shift, and who within your family or entity structure is the ideal recipient for the assets or income. And this is where a knowledgeable and creative professional tax planner can prove value to the family. Tax rules may make it difficult to shift income—for example, you cannot assign income to another taxpayer once it has been earned—or the rules may limit the tax benefits of income shifting—for example, the so-called kiddie tax rules. Gift and wealth transfer issues must also be considered as part of this strategy. Thus, global family planning should be well thought out and implemented early.

Converting income

Arranging your investments to convert income to categories that enjoy more-favorable tax treatment is another highly effective strategy in times of high tax rates. For example, interest income from banks and fixed-income securities is taxed at ordinary income rates—up to 35%. To reduce the tax burden on investment earnings, consider placing funds in investments whose earnings are not taxed at all—such as municipal bonds—or are taxed at the more favorable dividend rates (by investing in high-yielding equities).

Example: Parents Dan and Brenda were considering purchasing low-leveraged rental real estate that was expected to produce taxable net rental income annually. Because they (the senior generation) were under the highest marginal tax rate (35%), it was decided that their adult children should purchase the real estate. The second generation was under the 25% marginal tax rate, resulting in an expected 10% rate advantage. Dan and Brenda loaned the funds to the second generation to finance the transaction at the minimum rate allowed by the Internal Revenue Service (IRS) (known as the applicable federal rate), which was a rate superior to one that the second generation could obtain from third-party lenders. This resulted in lower interest expenses (and increased profits) to the second generation. In addition, the second generation would participate in all of the upside (capital appreciation) on the real estate. Through careful planning, income (current taxable income as well as future appreciation) was shifted from the senior generation to the second generation. The overall tax liability of the family decreased from 35% to 25%, and the wealth transfer objectives of the family were enhanced.

The amount of your investment earnings that you retain—the after-tax rate of return—is highly impacted by your marginal tax rate. As your marginal tax rate increases, the benefits of converting investment income from ordinary income to capital gain income or tax-free income multiply. In anticipation of the increase in tax rates expected in 2011, taxpayers should reevaluate their portfolios and their after-tax returns on taxable investments to determine whether tax-free investments could produce more-favorable after-tax returns.

Tactical areas to consider for 2009 tax planning

As mentioned earlier, no laws need to be passed for higher tax rates to take effect; existing tax rate cuts will expire and the shift in tax rates (up to 39.6% for

high-income taxpayers) will happen automatically. In situations in which your rate is lower now than it will be in the future, your tax-planning approach may be exactly the opposite of the one you've taken over the past few years with relatively stable tax rates: The most effective tax plan will accelerate income into the lower-rate years and defer deductions to the higher-rate years. Recognizing income before rates go up on such items as bonuses, distributions from retirement plans, and proceeds from selling property may be appropriate before the rates increase. Conversely, if you have deductions, delaying those actions (charitable contributions, paid bonuses) allows the deductions to fall in the years when rates increase.

Other areas to consider given the impact of an increased tax rate:

Increased tax rate on long-term capital gains and dividends

Currently, the maximum tax rate on long-term capital gains and dividends is 15%. That rate is scheduled to remain in place through the end of 2010, at which point the rate for long-term gains will return to 20%. However, it is important to remember that in 2011 a special reduced long-term capital gain rate for five-year long-term gains is to be reinstated. (You

must have purchased the asset after 2000 and held the asset for more than five years to qualify for a reduced rate of 18%.) Additionally, for taxpayers who make up to \$250,000 a year, the Obama Administration has proposed to continue the 15% rate on long-term gains.

More significant than the increase in long-term capital gain rates, when the current 15% rate expires, the rate on dividends is scheduled to increase from 15% to 39.6% starting January 1, 2011. That change, coupled with increased ordinary income tax rates, could make dividend-paying stocks less attractive in some portfolios. However, additional tax relief for dividends could be enacted. For those making more than \$250,000 a year, the Obama Administration has proposed (1) that the dividend tax rate go to 20% from 15% (rather than to 39.6%) and (2) that those not reaching that threshold see their rate remain at 15%. The table below summarizes current and expected tax rates on investment income.

Given the significant increase in the capital gains and dividend rates, consideration of the impact of these changes should be a part of your tax plan. For example, if you were considering taking any capital gains, it may be advantageous to do so

Maximum marginal tax rates on investment income

	Interest	Dividends	Long-term capital gains
Currently for 2009 and 2010	35%	15%	15%
Current schedule beginning 2011	39.6%	39.6%	20%
Obama proposal beginning 2011 <i>Income > \$250,000</i>	39.6%	20%	20%
<i>Income ≤ \$250,000</i>	35%	15%	15%

before the rate increase in 2011. If you have capital losses, the opposite applies; from a strategic standpoint, deferring those losses (if it fits with your overall financial plan) to 2011 would use the higher tax rate to your advantage, since the losses would offset gains that are subject to higher tax rates. While most of the time you would recognize a loss as soon as possible to obtain the tax benefit, in this environment that may not be the best plan.

Impact of the restored phaseouts

Under the Clinton Administration, tax policy was changed such that higher-income taxpayers could not benefit from personal exemptions, and so they lost the benefit of much of their itemized deductions. Itemized deductions and personal exemptions were phased out based on adjusted gross income. The Bush Administration steadily reduced itemized deductions and personal exemption phaseout rates for higher-income taxpayers from 2007 through 2009. Now, under the Obama Administration, the phaseout of personal exemptions and itemized deductions will resume as under Clinton, starting in 2011. Higher-income taxpayers could lose up to 80% of their itemized deductions (subject to certain limits and exclusions), as well as all of their personal exemptions, if their income exceeds certain levels.

Itemized deductions

Taxpayers have the right to reduce their taxable income by claiming itemized deductions that fall into one of five categories: state and local taxes, charitable contributions, interest expense, casualty losses, and miscellaneous deductions—the last including investment management fees, tax return preparation fees, and unreimbursed employee business expenses. Under Clinton, limits were put in place for high-income taxpayers—meaning, taxpayers were required to reduce their itemized deductions by 3% of the amount that their adjusted gross income exceeded a threshold. (The threshold is \$166,800 for 2009 returns and is indexed each year for inflation.) There was an overall cap so that taxpayers could not lose more than 80%

of itemized deductions; and certain deductions such as investment interest expenses were not subject to the phase-out at all. So, under Clinton, taxpayers could lose up to 80% of itemized deductions. Under Bush, phase backs were put in place regarding the amount of itemized deductions taxpayers could lose—effectively reducing the calculation from 3% to 1% of the amount that income exceeded the threshold. The Obama Administration will undo the phase backs of itemized deductions starting in 2011, at which point the Clinton policy of 3% will be reinstated for high-income taxpayers.

Example: Bill and Jean have an adjusted gross income in 2011 of \$1,180,000, with itemized deductions of \$100,000. Assume the phaseout threshold for 2011 is \$180,000 (\$166,800 as indexed for inflation). Based on the calculation, they lose \$30,000 of their itemized deductions as 3% of the amount by which income exceeds the \$180,000 threshold: $\$1,180,000 - \$180,000 = \$1,000,000 \times 0.03 = \$30,000$. Since \$30,000 is not more than 80% of their total itemized deductions, the phaseout is \$30,000.

A common misconception is that phaseouts are tied only to the amount of deductions. However, as discussed earlier, while there is an overall cap based on 80% of deductions, the primary determinant of the phaseout amount is based on income level. This leads to two important planning points. First, if a taxpayer's income is sizable, the 3% phaseout will have a large impact in terms of the loss of deductions. Second, because the calculation is tied to income, every dollar of deductions created once the taxpayer has reached the maximum phaseout still reduces the taxable income dollar for dollar. For example, if there already are itemized deductions in excess of the calculated maximum phaseout, then there is no additional loss of benefit for adding additional deductions. This is good to bear in mind when determining the tax benefit related to whether to accelerate itemized deductions into the current tax year.

Example: Assume Bill and Jean make an additional charitable contribution at year-end, bringing their total itemized deductions to \$200,000. The phaseout calculation remains unchanged, at \$30,000, since it is based on adjusted gross income, which did not change. Therefore, Bill and Jean receive 100% of the tax benefit of the additional contribution.

AMT planning

The alternative minimum tax (AMT) continues to be a widely discussed and hotly debated topic; and taxpayers need to be educated about it and actively plan for it. First instituted in 1969, the AMT was designed to ensure that high-income taxpayers, who had historically benefited from various tax preference items under the regular tax system, pay at least a minimum amount of tax each year. The AMT system is a tax system in parallel with the regular income tax system, but it generates an alternative tax liability by applying different rules for determining alternative minimum taxable income. The AMT incorporates a flat tax rate, and it limits, or eliminates, the benefit of certain tax deductions and credits. The AMT system acts on the premise that the taxpayer should pay the higher of the regular tax amount or the minimum tax amount. As a result, the regular income-tax-rate reductions enacted in past years are not fully realized by taxpayers who find themselves subject to the AMT. Essentially, if you happen to be an AMT taxpayer, it changes your tax rate. You would no longer be subject to the (new) 39.6% marginal tax bracket; you would instead be in a 28% bracket, thereby impacting your tax-planning strategy related to accelerating income and deferring deductions.

Taxpayers who are more susceptible to the AMT include those with significant long-term capital gains and dividend income that is subject to preferential low-income tax rates, and/or those who have large differences between AMT taxable income and regular taxable income due to the add-backs or deductions disallowed for AMT purposes

(sometimes called tax preferences or adjustment items). The key deductions that are not allowed for AMT purposes are state and local income taxes, property taxes, and investment advisory fees. In addition, depreciation is based on a longer recovery period for AMT purposes, and the bargain element of incentive stock option exercises is included in AMT taxable income even though it is not taxable for regular tax purposes. Therefore, the AMT can affect (1) retirees; (2) taxpayers with high state tax deductions such as in California, the District of Columbia, and New York; (3) corporate executives with large exercised incentive stock option amounts; (4) business owners with large depreciation deductions or net operating losses; and others. If you have traditionally been an AMT taxpayer or believe you're a target for the AMT for 2009, consider—preferably under the guidance of a professional tax adviser because of the complexity of AMT applications—how this impacts your planning strategies.

Because a taxpayer always pays the greater of regular tax liability or the AMT liability, a key factor to consider in AMT planning is the break-even point where the taxpayer's regular tax and AMT are approximately equal. Stated differently, it's important from a planning standpoint to understand—if you're not under the AMT—how much more in deductions you could utilize before your AMT liability becomes greater than your regular tax liability. Generating additional deductions until you reach that break-even point will generally result in tax savings equal to your marginal tax rate (35%). However, generating additional deductions beyond that break-even point either (1) will result in reduced tax benefits (at the lower, 28% AMT rate) or (2) could result in no tax benefit at all—if the deductions are tax preference items not deductible for purposes of the AMT. Conversely, if you're under AMT, it's important to calculate how much more income could be accelerated into the current year before you reach the break-even point where your regular tax liability will become greater than your AMT liability. Acceleration of income below

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that breakeven will generally increase your tax liability by a 28% marginal rate compared with the regular tax rate of 35%. However, acceleration of income beyond that breakeven would result in a 35% marginal rate on the accelerated income.

An inadequate understanding of tax rules and their potential impact on your goals and strategies could jeopardize your assets and long-term plans. Therefore, it's very important to explore and plan for the AMT by running your projected tax calculations under both the regular tax system and the AMT system for the current year and for several years into the future, focusing on proper management of your overall tax liability for longer than the current year.

For a more detailed discussion of the AMT, visit pwc.com/pfs.

Tax attributes

When planning for income taxes, don't forget about tax attributes that may be available as carryforwards from prior tax years. Such tax attributes might include capital loss carryforwards, net operating loss carryforwards, passive activity loss carryforwards, and carryforwards of unused itemized deductions from prior years, such as charitable contributions or investment interest expense. These carryforwards could significantly reduce your tax liability for the current year or offset the tax cost associated with a particular transaction you may be contemplating.

Capital loss carryforwards

Given the economy and the performance of the financial markets over the past two years, it's not uncommon for high-income taxpayers to have large capital losses from their investment portfolio, be the losses realized or not. There are two alternatives to consider for dealing with unrealized capital losses. The first alternative is to sell the security and recognize the loss. Any loss recognized can be fully utilized to offset capital gains recognized in the current tax year. Losses in excess of realized capital gains can offset up to \$3,000 of other income in your tax return. Any excess capital losses over and above

this amount will create a capital loss carryforward to future years. The carryforward can be carried forward indefinitely and can offset capital gains on future tax returns until the loss is fully utilized. Without capital gains, the carryforward can also be used in each future year to offset \$3,000 of other income a year. While capital loss carryforwards can be carried forward indefinitely without expiration, they cannot be carried back to recover gains from previous tax years. Making the decision to exit a security and trigger a capital loss should be based on sound investment strategy. You should also beware of the wash sale rules if you wish to recognize a capital loss: The wash sale rules provide that if you recognize a loss on a security and repurchase the same security within 30 days, the loss is not currently deductible for tax purposes.

The second alternative for dealing with unrealized capital losses is to delay recognizing the loss until the year in which the loss would produce the most tax benefit. Of course, this assumes that a sound investment policy and your investment goals are not compromised by continuing to hold the security. Delaying recognizing the loss preserves your flexibility to recognize the loss at a time when it is most beneficial to you. For example, a capital loss carryforward from prior realized capital losses will offset both short- and long-term capital gains recognized in the current year. Short-term gains are taxed at the maximum tax rate—soon to be 39.6%—while long-term gains are taxed at only 15%—soon to be 20%. Once the capital loss carryforward is in place, you cannot “elect” when to use it; it will offset the first capital gains recognized, be they long-term or short-term. Therefore, it may make more sense to sit on the unrealized loss until a more strategic time presents itself to offset short-term, rather than long-term, gains.

Example: It's December 2009.
Assume Bill has recognized \$100,000 in long-term gains and no short-term gains during the year. He has unrealized long-term losses in his portfolio of \$100,000 that could fully offset his

taxable gains. Using this strategy would save Bill \$15,000 in taxes for 2009 (since the long-term gains would have been taxed at 15%). However, assume Bill expects to recognize \$100,000 of short-term gains in 2010. Bill could decide to delay recognizing the capital losses until 2010. This way, assuming Bill has no long-term gains during the year, he can use the losses to offset the short-term gains, producing tax savings of \$35,000, since the short-term gains would have been subject to a tax rate of 35%. Delaying recognizing the loss produces a \$20,000 tax savings for Bill.

Special rules for losses related to Ponzi schemes

In March 2009, the IRS released two pronouncements meant to address the losses incurred by those who fell victim to fraudulent investment schemes, such as those in the widely publicized Madoff and Stanford cases. These rulings were very favorable to taxpayers, providing the following key benefits:

- / As discussed earlier, capital losses can offset capital gains but cannot offset ordinary income except to the extent of \$3,000 a year. Ordinary losses are not subject to such limitations. The IRS clarified that defrauded investors are entitled to a theft loss, which is not a capital loss. As theft losses, the losses can offset dividends, interest, salaries, and other ordinary income amounts. Importantly, if the theft produces a net operating loss for the year, such loss can be carried forward to future tax years or can be carried back to previous tax years to recover taxes previously paid.
- / Unlike most personal theft losses, which are deductible only to the extent they exceed 10% of adjusted gross income for the year, the IRS provided that investment theft losses are allowable in full, without reduction. For high-income taxpayers, this is a tremendous benefit.
- / The IRS provided guidance on when losses can be claimed, given that lengthy trials can prevent involved taxpayers from knowing the full impact of a fraudulent scheme for many years. The new rules generally provide that

losses are allowed in the year fraud is detected and indicate that most taxpayers can deduct 95% of their net investment minus expected recoveries from insurance or other sources at that time. If it is subsequently determined that the loss was more (or less) than the 95% deduction claimed, a true-up is claimed in the year the full extent of the loss is known.

- / The guidance clarifies that the amount of the loss that can be claimed includes not only the unrecovered original investment but also any income that was reported on prior-year returns.

In short, the IRS allows investment theft losses to be treated as ordinary losses and allows most of the loss to be recognized immediately. Objective criteria are set forth to allow victims to begin dealing with their losses right away and to determine whether their situation qualifies for the special treatment provided in the guidance. While these rulings were issued following the Madoff scandal, the rulings are not restricted to victims of that specific Ponzi scheme; they apply to any investment theft loss that meets the criteria set forth in the guidance.

Looking ahead to 2010

Roth IRA conversion

One of the most exciting income tax changes for 2010 that should be considered in your tax planning involves the Roth IRA. Currently, high-income taxpayers are not permitted to establish and contribute to Roth IRAs, nor are they allowed to convert existing traditional IRAs into Roth IRAs. While high-income taxpayers will still not be permitted to make annual contributions to a Roth IRA, starting in 2010 high-income taxpayers will have the option to convert traditional IRAs to Roth IRAs. Many high-income taxpayers have large IRA balances, particularly if they've established an IRA rollover account to defer taxation of qualified retirement plan distributions.

With a Roth IRA, you contribute after-tax dollars, but the income is not subject to tax when removed, provided the distribution satisfies a five-year holding period

and takes place after age 59½, or on account of death or disability, or to meet first-time-home-buyer expenses. The tax-free accumulation of income is particularly attractive for younger taxpayers, because the sheltering of years of earnings in this manner can lead to enormous compounding. A second advantage of the Roth IRA is that the predeath required minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs, which means the account can continue to grow, tax free, after age 70½. The Roth IRA is a fabulous asset to leave to children or grandchildren, since it has no built-in tax liability associated with it.

The tax consequence of a Roth IRA conversion in 2010 or later years is that you must pay income tax on the taxable portion of the IRA upon conversion. This can be a significant tax cost. However, remember that once the IRA becomes a Roth IRA, all future appreciation and income have the potential to grow tax free. Given recent market declines in retirement accounts, a conversion to a Roth in early 2010 may be much less costly than it would have been in the past, when IRA values were higher. Additionally, conversion to a Roth during a depressed market would allow any recovery in the market value to fall under the more favorable Roth rules. Normally, the tax related to a Roth conversion must be paid on the tax return for the year of the conversion. However, conversions in 2010 come with a special incentive, by which you can elect to pay the income tax associated with the Roth conversion over two years, in 2011 and 2012.

Example: Janet has an IRA worth \$500,000. The entire amount is taxable when withdrawn (no nondeductible contributions were ever made). Janet elects to convert her IRA to a Roth IRA in 2010. She must pay federal income taxes (and state income taxes, if applicable) on the entire \$500,000 (a tax of \$175,000, at 35%). Janet may include the taxable income on her 2010 return, or, if she makes the special election, she may

include one-half of the income on each of her 2011 and 2012 returns. Once she makes the conversion and pays the tax, future distributions from the Roth IRA will be free from income tax, provided the Roth rules are followed.

Special considerations

IRS audits of high-wealth individuals are on the rise

For high-net-worth individuals, the likelihood of an IRS audit is on the rise. IRS statistics show that examinations of individuals with incomes of over \$200,000 increased by more than 24% from 2007 to 2008. In addition, the overall examination coverage of this filing segment of taxpayers has risen to nearly 3%.

This recent trend and the likelihood that it may continue are the results of a number of factors, the first of which is that historically, tough economic times correlate with an increased IRS focus on enforcement. The tax gap (the difference between amounts owed and amounts paid voluntarily) is estimated to be \$350 billion per year. That number generates political pressure to elevate audit coverage, end abusive transactions, and increase collections.

The second factor is due to frequent updates to the criteria and formulas used in selecting returns for individual filers and increased compliance checks by IRS examiners for certain officers, partners, or shareholders/owners of businesses or other entities. The IRS initiates many individual audits from examinations of related returns. For example, a shareholder or owner of a business could be examined as a result of an audit of the business return. In addition, the IRS routinely inspects the most significant corporate officers and decision makers as part of every corporate audit. Through this process, many individual returns get identified for audit.

The third factor contributing to increased audits is that the IRS has received authority to increase the number of staff responsible for examining individual

returns. Recently, approximately 4,000 additional staff were hired to address individual audits and increase collections, including increased IRS scrutiny of individual returns.

Individuals are subject to three different types of audits.

- / Correspondence audits are typically conducted via the mail and involve verification of certain tax return line items such as charitable contributions, home mortgage interest expense, and stock gains and losses. From 2006 to 2007, correspondence audits increased by 148%. While those audits can be complex and difficult to respond to via mail, an immediate assessment, including penalties, is made (and could include the issuance of a statutory notice of deficiency) if an individual does not respond.
- / Office examinations involve face-to-face audits with IRS tax compliance officers in an IRS office. These examiners have significant technical training and knowledge of the tax law, and they examine such issues as Schedule C income and expenses, passive-activity losses, casualty losses, and capital gains.
- / Field examinations are face-to-face audits performed by IRS revenue agents, typically at the taxpayer's home or office. These agents have formal accounting degrees and, typically, other credentials; a deeper technical base; and training for examination of partnership and corporate tax returns. These tend to be in-depth audits.

As the likelihood of audits of high-net-worth individuals continues to increase, proactive preparation, a focus on compliance, and an understanding of what the IRS will look for are the keys to an efficient and successful examination. In addition, individuals selected for audit should consider—at the first notice of an audit—working with a tax adviser with significant IRS expertise. Working with a tax adviser can be the difference between rapid resolution or increased penalties, interest, and related expenses.

Misconceptions

When increased taxes seem inevitable, people sometimes gravitate toward one of two extremes: The first extreme is to throw up their hands and do nothing. The other is to allow taxes to consume their every thought and action.

“My taxes are going up, and there’s nothing I can do.”

Rising taxes make it even more important to plan, and the benefits of tax planning are increased in terms of tax dollars saved when you implement sound planning strategies. Even in the face of rising taxes, there are a number of planning tools that you can use to increase benefits. While your taxes might increase overall, with careful and thoughtful planning the increase might not be nearly as impactful as it would be if you took no action.

“The plan that minimizes my taxes is always the best approach.”

While reducing your overall tax outlay is always an important focus in financial planning, taxes should not drive everything. Investment policy decisions should be made based on sound economics and not just tax savings, and all tax plans should start with your individual financial goals. The role of tax planning is to assist you in reaching your goals in the most tax-efficient way possible.

Conclusion

Particularly in this climate of rising tax rates, proactive tax planning is a vital part of taxpayers' overall financial health. While taxes may increase, taxpayers are not without tools and strategies to keep their tax postures as efficient as possible. However, the increase in tax rates may call for steps that are different from the techniques and strategies taxpayers have used in previous years. We encourage you to be engaged in the process and to work with your tax adviser to determine the tax tools and techniques that will best position you at tax time.

For more information on strategic tax planning, including current tax rate information, visit pwc.com/pfs.

Managing your portfolio

Amid continued economic uncertainty and rising tax rates, it's critical to understand the basics of investment planning, investor behavior, asset location, and documentation of investment decisions. These fundamental principles form the foundation upon which successful individual investment and wealth management plans are built.





If nothing else, the macroeconomic events of the past 12 months have demonstrated that the world's financial markets are tightly connected. As the US economy began to slide into recession, almost all countries around the world became deeply affected. And as investors experienced the pain of declining asset values, everyone was hurt, but those with portfolios less concentrated in equities were hurt less. Two things became very clear: asset allocation does matter, and diversification helps manage portfolio risk.

One consequence of the financial crisis and the US government elections of 2008 is almost certain: income tax rates will be rising. For individuals in the highest tax brackets, it becomes even more important to invest in a tax-aware manner and pay close attention to the location of their investment assets. Increasing the tax efficiency of their portfolios will have a direct positive impact on bottom-line returns.

In this environment, it's worthwhile to review the basics of investment planning, investor behavior, asset location, and documentation of investment decisions.

Investment planning: The basics

The investment-planning and decision-making process is a logical sequence of actions that you should perform before choosing an investment vehicle. These actions include:

- / Identifying goals, objectives, and constraints
- / Analyzing the risk/return trade-off and how to improve it
- / Allocating assets and implementing your investment strategy
- / Reviewing performance

Goals, objectives, and constraints

The first step is to identify your investment goals, objectives, and constraints. Goals can be short-term—such as investing to fund the purchase of a vacation home within a year or two—or long-term, such as investing to fund retirement. Investment objectives would include such things as investing to grow capital, preserve capital,

or create a moderate yield. In addition, you need to take into account the constraints you face in implementing the strategy, such as the dollars available to invest, your risk tolerance, and your need for liquidity.

Risk/return trade-off

The next step is to focus on the risk/return trade-off and go beyond the expectation of taking more risk in order to achieve higher returns. Since your “real” return (nominal return minus taxes and inflation) is the true measure of your wealth gain, you need to track your real investment return.

Just as understanding that real return is important in your analysis of risk and return, it is also important to understand the type of risk you are dealing with. Most people focus on return volatility, but there are many risks to consider when developing an investment strategy. Because investors each weigh each risk differently, there is no one portfolio that fits all investors. The following describes some of the risks most investors consider when making investment decisions.

Asset allocation

This technique is considered the underlying principle of modern portfolio theory, as follows: Asset classes are groups of various investments with similar characteristics. Since asset classes will react differently to similar economic conditions, it is possible to combine several asset classes whose performances are not closely related. This creates a portfolio return that will be less than that of the return of the best-performing asset class but above that of the worst-performing asset class while reducing the volatility of the overall portfolio.

Most investment managers acknowledge that the asset allocation decision accounts for over 80% of performance variability over time and is much more important than individual security selection and other factors in control of risk. Therefore, it makes more sense to concentrate on asset allocation and asset class selection than trying to pick the individual security that will produce the best desired performance.

Systematic risk

The following are classified as systematic risk—meaning, they are nondiversifiable.

/ *Purchasing power (inflation) risk*

Inflation is a serious risk to your long-term financial security. As inflation increases the prices you pay for goods, you need to increase income or generate investment growth to meet the increased cost of living. If there is no growth, then you will have to consume your existing assets in order to generate the income needed to meet the increased costs if you desire to maintain your standard of living.

/ *Deflation risk*

Deflation risk is just the opposite of inflation risk. It is the risk that asset values will decline at a greater rate as general price levels fall during periods of severe recession or depression.

/ *Interest rate risk*

Interest rate risk is the tendency of securities, especially a fixed-income instrument, to move inversely with changes in interest rates. Rising interest rates decrease the current market price of fixed-income securities because current purchasers require a market-competitive yield.

/ *Exchange rate risk*

Exchange rate risk occurs when one currency is converted into another. This risk is relevant only for clients who acquire securities denominated in a foreign currency.

/ *Political risk*

Political risk is an important concern, particularly when investing in countries where political and social unrest has long been part of the landscape. Political actions can wreak havoc in the financial markets.

Unsystematic risk

This is company-specific or industry-specific risk and can be reduced only through proper diversification. Company-specific risk is the chance that some event might occur that negatively impacts the financial performance of the company.

Two of the risks worth highlighting because of their impact in 2008 are event risk and liquidity risk.

/ *Event risk*

Event risk is the risk that some uncontrollable event (political, environmental, financial, social, and so on) will occur that could have a significant impact on your portfolio. The market crash in the second half of 2008, for example, qualifies as such an event: The broad equity market as measured by Standard & Poor's 500 Index dropped 53% in 83 days during that period. Even the best-constructed equity portfolio was negatively impacted by such a dominant market decline.

/ *Liquidity risk*

Liquidity risk is the chance that an investment cannot be sold easily or efficiently. Some investments might be hard to sell because they are less liquid and difficult to find a market for, particularly during down markets. Such was the case in 2008: As the stock market declined and credit became virtually impossible to secure, these events helped create the perfect liquidity storm. Many investors grew to rely on home equity loans as sources of liquidity but have since found that source virtually dried up. Some investors turned to their money market and bank accounts, and some found they could not make withdrawals. When the same investors tried to sell assets (stocks, bonds, alternative assets, and the like), they found that the price was too low or there were no buyers. This continues to be the case for certain asset classes such as real estate.

Many investors ignored the basic rule of personal liquidity risk management: Have a cash pot available to pay living expenses in the event of a personal crisis. Instead, they invested in other assets in search of higher returns, with the expectation that they could always borrow to meet short-term liquidity needs. Advisers differ, but depending on each investor's situation, cash on hand to cover one to three years' living expenses is a prudent investment strategy.

Asset allocation is a form of diversification, since you're not putting all your eggs in one investment basket. By having several asset classes, you have several baskets. However, you also need to diversify *within* your asset classes. For example, if you owned one cash account, one intermediate-term government bond, and one stock, your portfolio would be allocated but not diversified. You would achieve more diversification by owning a portfolio of bonds or stocks such as can be obtained through the purchase of a mutual fund.

The market crisis of 2008 confirmed that asset allocation does matter. Although all portfolios experienced the wrath of the markets' downturn, those that were diversified (invested in bonds, stocks, cash, and alternatives) performed better than those heavily concentrated in equities. Portfolios diversified within a variety of asset classes (including alternatives when appropriate), as well as diversified geographically, are necessary to help manage risk in today's investment world.

Reviewing performance

It is likely that personal financial goals and objectives will change as time passes. Therefore, revisit your financial plan on an annual basis and decide whether your investment portfolio is still suited for achieving those goals and objectives or whether changes should be made.

Part of the review process will involve rebalancing the portfolio. Rebalancing will be necessary as the portfolio grows disproportionately for each asset class and/or as new cash is added to the mix. Either of these events will change the original asset allocation, which can materially change the portfolio's risk. By rebalancing the portfolio, you'll be restoring it to the original asset allocation that was established during the planning process.

Investor behavior

The investment-planning and decision-making process may be a logical sequence of actions, but an investor's psychology can disrupt the best-laid plans.

Generally speaking, investors tend to mirror the current state of the economy and the business cycle. If things are looking good, they tend to be positive; if things begin a turn for the worse, their attitudes turn negative. Most investors tend to focus on the present (current job situation, current economy, recent stock movements, and so on) and begin to make decisions that are very short-term focused and often counterproductive.

The difficult task for the investor is to be slightly ahead of the crowd by selling before markets fall and buying before they begin to rise. Unfortunately, the skill of timing the markets' movements is extremely difficult to master.

A more reliable strategy that has proved effective in managing risk and capturing reasonable returns is the discipline of a systematic strategic asset allocation focused on achieving long-term goals. When combined with tactical rebalancing, it can go a long way to help keep an investor's behavior in check and avoid going too far off course.

Asset location

Up to this point we have not mentioned much about the impact of income taxes on investment decisions. Make no mistake: Income taxes matter in the investment process, and with the prospect of increasing tax rates, they'll matter even more.

One way to help improve the tax efficiency of your investment portfolio is by what is often referred to as asset location. Essentially, asset location is the process of determining where the best place to own an investment is, given your goals for the investment. Wealthy individuals' investments are rarely held in one account or entity. They're usually held in different buckets that have been established to help implement their financial and wealth transfer planning over time.

As of this writing, tax reductions enacted in 2001 and 2003 are scheduled to sunset at the end of 2010. In addition, new legislation has been proposed that will increase income tax rates and limit

deductions for individuals. Therefore, the asset allocation decisions you make must take into account the impact of income taxes on portfolio return.

Each investor bucket is established for a particular purpose and therefore requires a specific investment strategy. Each bucket can be invested in either taxable or tax-deferred accounts—such as individual retirement accounts (IRAs), 401(k)s, and deferred compensation plans—that delay income taxation. They may also be invested in accounts such as Roth IRAs and college savings plans, which offer potentially tax-free investment opportunities.

Which investments to own inside these accounts depends on the investment purpose for that bucket. For example, taxable bonds generate interest income that is taxed at ordinary income tax rates and for that reason are often held in tax-deferred accounts. Stocks may distribute qualified dividends that are taxed at favorable rates (currently, 15%; proposed, 20%) or nonqualified dividends taxed at ordinary income tax rates. Stocks also generate capital appreciation that could be taxed at ordinary income rates (if held less than one year) or favorable tax rates (currently, 15%; proposed, 20%) if held longer than one year. For this reason, stocks have generally been held in taxable accounts. Of course, if the investment holding period is very long, owning stocks inside tax-deferred accounts may make more sense because their potentially higher returns could make up for the ordinary income tax rate at distribution.

Asset location decisions are often very complicated and must take into account many variables besides income taxes. Other issues—like estate and gift-planning goals, income and liquidity needs, age of the investor, and investment time horizon for the portfolio—will all need to be considered before deciding on which asset location would produce the most tax-efficient investment environment and still meet the desired goals.

For rates and other information related to capital gains, visit pwc.com/pfs.

Documenting the investment decisions, strategy, and process

The investment strategy and process are typically documented by creating an investment policy statement (IPS).

There are a number of excellent reasons that a well-thought-out and formally written IPS is so important. Unfortunately, it often is created without much thought or often gets forgotten.

Two reasons for creating an IPS are that:

- / The IPS can be an invaluable communication tool between family members and close professional advisers such as accountants or attorneys. It provides documentation of the investment process for the portfolio and evidence for the reasons investment decisions were made. It will also help with transition planning in the event of a death, since all parties would understand why assets were invested as they were.
- / The IPS forces the investor to think long term and create a well-thought-out investment plan. It also helps stop the second guessing of investment decisions in the future. During a bull market, most investment strategies generate impressive results. However, it's during a bear market that the IPS can have a calming effect: by reminding the investor why the investment portfolio is structured as it is and helping avoid emotional, short-term investment decisions.

The investment policy statement should be simple, forthright, and understandable. It should (1) provide background on the purpose of the investment portfolio and how the assets will be used in the context of your financial plan, (2) detail the desired asset allocation, (3) provide a strategy for automatically rebalancing the assets, (4) set out clear and definable performance standards for the portfolio managers, and (5) define the duties and responsibilities of all parties involved in the management of the portfolio's assets.

Conclusion

Investment planning and wealth management are complex undertakings that, while rooted in a foundation of fundamental principles, must be approached differently to address the unique needs and expectations of each individual or family.

It is not uncommon, when managing wealth, to discover that several competing goals must be considered. Developing strategies to meet those competing goals requires careful thought, and, often, several meetings with your adviser to model the potential solutions before choosing the one that works best for you.

Example

A couple has investable assets of \$20 million and spends approximately \$250,000 annually on their living expenses and lifestyle. The couple wants to maintain that standard of living during retirement as well as provide inheritances for their two children. In addition, the couple would like to make charitable gifts with the assets that are not required to support their lifestyle or to meet their inheritance goal for their children.

The investment strategy for this couple will need to take into account many factors such as:

- / Income and spending levels
- / Legacy objectives
- / Charitable goals
- / Taxation
- / Investment time horizon

The solutions for these goals are best crafted by breaking the wealth into buckets.

Bucket 1: Liquidity

Based on the annual \$250,000 lifestyle need, there should be liquid assets (such as cash and equivalents) set aside to be able to meet one to three years of lifestyle needs. Therefore, approximately \$1 million should be invested in tax-efficient (possibly tax-exempt short-term municipal bonds) cash and equivalents.

Bucket 2: Lifestyle

These assets should be invested to help provide the living standard required by the family. Approximately \$15 million will be allocated to help achieve that goal. The strategic asset allocation for this portfolio should create only moderate risk, since these assets are needed to provide for the family's living needs. Approximately 50% in cash and fixed income, 45% in equities, and 5% in alternatives might make sense. The assets will be held in IRAs, 401(k)s, and deferred compensation plans as well as other accounts; and therefore, careful thought will be needed for the asset location decision. Tax efficiency is very important, since it is likely that this family will be paying income taxes at the highest marginal tax rates. Planning must also be done on how to create the \$250,000 that the family needs annually for living expenses. Will the money come from interest, dividends, or principal distributions? Will distributions be taken from the IRAs, 401(k)s, or deferred compensation accounts?

It may make sense to hold the tax-inefficient hedge funds inside the tax-deferred accounts and consider using tax-exempt municipal bonds for the fixed-income allocation that is held in taxable accounts. For the equity allocation, they should consider using exchange-traded funds, low-turnover mutual funds, index mutual funds, and tax-aware, separately managed accounts for those investments held in taxable accounts. Alternatively, they should consider taxable bond investments and higher-turnover equity investments for the tax-deferred accounts, since generating short-term gains will not be an issue.

Bucket 3: Children's inheritances

These assets (\$1 million per child) are earmarked for the children's inheritances. The investment time horizon is long-term, since the money will be invested over their lifetimes. Therefore, a more aggressive investment strategy (e.g., 60% equities, 30% fixed income, and 10% alternatives) may be warranted. Asset location is still important because the family's estate plan may dictate that these assets be held in trust for the children's benefit. If that's in the form of a grantor trust, the tax consequences of the investments will flow back to the grantor (the parents) and be taxed just as any other taxable investment would be.

Bucket 4: Charitable giving

The remaining \$2 million of assets is earmarked for charitable giving. How those assets are invested can get very complicated based on how the family intends to make these charitable gifts. Things to consider would be the timing of the gifts; the charitable giving strategy to be used (charitable remainder trust, charitable lead trust, donor-advised fund, foundation, etc.); the taxable beneficiary of the trusts, if used; and the target amount of charitable gifts. If the assets were not held in one of the charitable trusts but in a taxable account that was set aside for the charitable giving, the investment income would flow back to the couple. At that point, investments like those discussed for bucket 2 may be appropriate. (For a more detailed discussion of charitable structures and planning, see chapter 3, "Charitable giving," page 24.)

Charitable giving

Private philanthropy has long been an important element of long-term wealth management plans. When building a charitable giving plan, it's important to consider the advantages, disadvantages, and tax considerations of the various charitable structures available and to select the ones that will best serve your philanthropic goals.



Private philanthropy has long been charitable organizations' cornerstone of financial support. From outright cash gifts to complex charitable structures, giving provides numerous benefits for society as well as a tax-efficient means for you, the donor, to transfer wealth.

The ability to benefit society while managing wealth transfer and income tax considerations makes charitable giving a powerful tool in your overall financial planning efforts. Beyond the benefit to society, there are many reasons that motivate an individual to consider adopting a charitable giving strategy—from the need to deal with a large, appreciated portfolio of securities to the desire to create a family giving program, to the need for an additional income stream.

Before evaluating why a donor might adopt a particular plan of charitable giving, it's helpful to understand some of the key alternatives available to individuals and families in structuring their overall charitable goals.

Creation and operation

There are a number of commonly used charitable structures. Each carries different tax considerations, so it's important to align your personal charitable goals with the structure that will best support them.

Public charity

A public charity is a tax-exempt organization created and operated exclusively for religious, charitable, scientific, literary, or educational purposes. It receives either broad public support or is a religious institution, school, hospital, or organization operated to support another public charity. Generally, gifts of cash to public charities are fully deductible up to 50% of a donor's adjusted gross income. Gifts of appreciated securities are generally deductible up to 30% of a donor's adjusted gross income. To the extent that the amount of a specific year's charitable gift(s) exceeds the adjusted gross income thresholds, excess contribution amounts are carried forward and are deductible for up to five years following the year of the gift.

Private foundation

A private foundation is a tax-exempt organization organized exclusively for religious, charitable, scientific, literary, or educational purposes. However, it does not meet the broad-public-support requirements that would classify it as a public charity—meaning, a foundation does not have to rely on volunteers and public donations to prove the extent of public involvement needed to define a public operating charity. Unlike public charities, private foundations generally pay a 1% or 2% excise tax on their net investment income, including capital gains.

Private foundations typically fall into two categories: operating and nonoperating. Nonoperating private foundations are required to make distributions to qualifying charitable organizations equal to at least 5% of the average fair market value of their assets each year. Operating foundations actively conduct programs of charitable activities rather than merely provide passive support for other charities. (Common examples of operating foundations are museums and libraries.) Nonoperating foundations tend to serve primarily as vehicles that distribute funds to other charitable organizations.

Gifts of cash to private nonoperating foundations are fully deductible up to 30% of a donor's adjusted gross income. Gifts of appreciated securities to nonoperating foundations are generally deductible up to 20% of a donor's adjusted gross income. One of the primary benefits of a private operating foundation is that gifts to such an organization are subject to the same adjusted gross income limitations as gifts to public charities are. In either case, the same five-year carryforward referenced earlier applies to gifts to any type of private foundation.

A private foundation is an excellent vehicle for developing an intergenerational plan for charitable giving. While there is no dollar amount threshold required to establish a private foundation, it is generally advisable to consider \$1 million as the minimum initial contribution to fund a private foundation—due to the significant administrative duties associated with the operation of this type of charitable entity.

Community foundation

Many of the larger metropolitan areas have community foundations that accept donations for the general benefit of those particular geographic areas. Community foundations are treated as public charities (not as private foundations), so the donor has a large degree of flexibility both in structuring the gift and in advising the foundation on how to benefit the surrounding community. For income tax purposes, gifts to a community foundation are treated the same as gifts to public charities are.

Donor-advised fund

Donor-advised funds have become popular choices for directing donations. This type of fund is a specially segregated donation to a public charity—meaning, the fund is distributed based on the donor's wishes. A donor does not have any legal right to direct specific uses for the donated funds, but most charities feel a moral obligation to follow the donor's wishes. Many mutual fund families, large banks, and community foundations have established donor-advised funds. For income tax purposes, gifts to a donor-advised fund are treated the same as gifts to public charities are.

Both a community foundation and a donor-advised fund are alternatives to establishing a private foundation because they avoid the record keeping, tax filings, and other administrative chores associated with a private foundation. A community foundation or a donor-advised fund can generally be established with smaller amounts than would be needed to justify the expense of maintaining a private foundation. In all cases, donors should make sure they understand the fee structure of the fund and the administrative services made available by the fund.

Supporting organization

A supporting organization is a privately organized, donor-influenced (but not donor-controlled) organization that supports a named public charity. In many respects, it's similar to a private foundation, the major difference being that the board of a supporting organization must

be linked to the public charity it supports (e.g., there are common board members). A supporting organization is treated as a public charity for purposes of the contribution deduction rules and does not pay an excise tax on net investment income like a private foundation does.

Once you know what type of charitable structure best aligns with your wealth management plan, you should solicit the help of your financial/tax adviser and any involved charitable groups. Donors need to take into account their current and future overall financial plans in order to determine whether their goals are attainable and manageable. Once a donor transfers assets as part of a plan of charitable giving, those assets move beyond the control of the individual or family. No such financial decision should be made without understanding its impact on one's current and long-term needs.

A major consideration in the ongoing operation of a charitable giving structure is how contributions will be made over time; gifts to public charities, private foundations, community foundations, donor-advised funds, and supporting organizations are generally the types of entities donors use for their plan of current giving for charitable purposes.

Alternatively, gifts that will benefit a charitable organization at a later date are often referred to as deferred gifts. The most typical deferred gift involves a transfer in exchange for a retained benefit or a lifetime benefit. Deferred gifts to charity can consist of annuity-type arrangements, remainder interests in certain types of property, and various types of charitable remainder or lead trusts. The flexibility inherent in being able to match the type of property to the type of charitable gift option is one of the primary advantages of deferred giving. In addition, when neither outright nor deferred giving is possible, there are other possibilities such as conservation easements or property restrictions.

Gift annuity

One of the most popular forms of deferred charitable giving is the charitable gift annuity. In its simplest form, the donor transfers cash, securities, or, in some cases, real estate to an established charity in exchange for the charity's promise to pay an annuity to the donor and/or other named beneficiaries. The value of the charitable contribution is the difference between the annuity value and the value of the property transferred. In addition, a portion of each annuity payment is deemed a return of the original investment and is tax free to the recipient over the recipient's life expectancy as determined by actuarial tables.

Example: Lisa contributes \$100,000 in stock (fair market value) with a tax basis of \$50,000 to her alma mater in exchange for a guaranteed annuity of \$5,300 per year. She will receive a charitable income tax deduction of approximately \$33,000, and each annuity payment will consist of an ordinary income piece, a capital gain

piece, and a portion that is a tax-free return of her investment. So, rather than selling the stock and paying taxes on the capital gain, Lisa has set up a plan wherein she gets an upfront charitable deduction, provides an asset for her alma mater, and has a guaranteed revenue stream for the rest of her life.

Remainder interest in a personal residence

A popular method of avoiding estate tax on a personal residence (i.e., a residence that is not your primary residence but is, say, a vacation home or a farm) while gaining a lifetime income tax charitable deduction is to give a remainder interest in that property to charity. In addition to the charitable contribution benefits, a gift of a remainder interest in a residence permits the donor to avoid capital gains tax from a potential sale. The income tax charitable deduction is based on the present value of the charity's remainder interest. Although the personal residence would be included in the decedent's estate, an offsetting charitable deduction is available for estate tax purposes.

Gift annuity

Advantages

- / Grants the donor a current charitable deduction
- / Reduces the donor's taxable estate
- / Provides the donor with a current income stream
- / Provides the charity with current assets
- / Requires less tax compliance than charitable remainder or lead trusts do (further details below)

Disadvantages

- / Donated assets pass to charity instead of heirs
- / Transaction is treated in part as a charitable contribution and in part as the purchase of an annuity

Remainder interest in a personal residence

Advantages

- / Grants the donor a current charitable deduction
- / Reduces the donor's taxable estate
- / Provides the charity with future real estate growth and expansion
- / Allows the donor to live in or use the house or farm for a term of years or for life

Disadvantages

- / Donated property passes to charity instead of heirs
- / The charity must wait to receive real estate
- / Gain on sale of primary residence exclusion may be lost

Conservation easement

A charitable contribution deduction is also allowed in connection with the transfer of a perpetual easement (a permanent restriction on the future use) in real property for conservation purposes. The contribution must be made to a qualified organization—generally a government entity or a publicly supported charity. In addition, the property must be used exclusively for conservation purposes such as preserving land areas for outdoor recreation by the general public; protecting a relatively natural habitat of fish, wildlife, and plants, or a similar ecosystem; preserving open space (including forests and farms); or preserving a historically important land area or certified historic structure.

The value of the contribution of a qualifying conservation easement is the change in fair market value of the property before and after the restriction. Absent comparable sales of easements, fair market value is determined by comparing the land's fair market value before the restriction is granted with the fair market value after the restriction is granted.

Charitable remainder trust

The charitable remainder trust (CRT) is a popular form of deferred giving and offers alternative structures to match the needs of donors. The transfer is accomplished by creating a trust with income paid to individuals, with the remainder going to charity. This form of charitable giving allows the donor or other named beneficiaries to receive from the transferred assets both an income stream and a current charitable deduction. When the trust's term ends, the remaining assets become the outright property of the charitable organization.

A CRT is an irrevocable trust created during the life of a donor or by an individual's will. Under the terms of the trust, a specified amount (not less than 5% and not more than 50%) of the trust's net fair market value is paid to one or more than one beneficiary (at least one of the beneficiaries must be noncharitable) on an annual or more frequent basis.

Conservation easement

Advantages

- / Provides a unique benefit for society through creation of a historic area/structure or preservation of outdoor space
- / Grants the donor a current charitable deduction

Disadvantages

- / Donated property passes to charity instead of heirs


Charitable remainder trusts

Advantages

- / Grants the donor a current charitable deduction for the value of the property transferred to the charity in the future
- / Reduces the donor's taxable estate
- / Provides the donor or designated beneficiary with a current income stream
- / Provides the charity with assets in the future

Disadvantages

- / Donated assets pass to charity instead of heirs
- / The charity must wait to receive donated assets



Charitable structures and wealth transfer often complement each other in an overall wealth management plan. Consider creating these elements alongside each other to increase their effectiveness.

A CRT can last for either the lifetime of an individual (or several individuals) or a period of years not to exceed 20 years. A CRT requires that the income beneficiaries be alive when the trust is created. The charitable remainder beneficiary may be a private foundation created by the donor. When the noncharitable interests terminate, the remainder must pass to charity.

There are two main types of CRTs: the annuity trust and the unitrust. The charitable remainder annuity trust (CRAT) pays a set dollar amount each year based on the fair market value of the assets at the time the trust is funded. The charitable remainder unitrust (CRUT) pays a dollar amount determined each year based on an annual valuation of the trust assets. The CRUT has flexibility in its structuring that can include a net-income-only payout with a makeup provision. This allows a donor (1) to transfer a non-income-producing asset to the CRUT (such as real estate), (2) to take the time to sell the asset, and (3) to make up the lower, income-only payments before the sale with larger payments after the sale proceeds have been reinvested to produce a higher amount of income.

A CRT generally does not pay income tax on investment earnings (dividends, interest, or capital gains). This permits the trust to sell appreciated property and not trigger current tax on the gain. Instead, the income beneficiary of the trust is responsible for income tax on amounts received from the trust.

Example: Jessie and John own stock worth \$1 million, which was purchased many years ago for \$500,000. They wish to diversify their holdings but would like to avoid a large capital gains tax. Instead, they place the stock into a charitable remainder unitrust so that the trust then sells the stock. The trust pays no income or capital gains tax on the sale and pays Jessie and John 10% of the trust's net fair market value annually for their joint lives. Jessie and John name their local art museum as the remainder beneficiary. The unitrust arrangement provides them with a charitable income tax deduction of approximately \$134,000 in the year of creation. Because the annual distribution is keyed to the fair market value of the trust each year, Jessie and John either enjoy the benefits of the trust investments from year to year if the investments increase in value, or they suffer the detriments from year to year if the investments decrease in value. Jessie and John's first annual payment would be \$100,000.

Charitable lead trust

Charitable lead trusts (CLTs) provide that the charity receives the income for a period of years and the remainder goes to a family member or noncharitable beneficiary. In essence, a CLT is the opposite of a charitable remainder trust. Like the CRT there are two types of CLTs: the charitable lead annuity trust and the charitable lead unitrust.

Charitable lead trust

Advantages

- / Provides the charity with current income
- / Provides the opportunity to reduce the donor's taxable estate
- / Grants the donor a current charitable deduction for all payments to be made to the charity if the donor is taxed on income as it is earned by the trust
- / Allows the donor or designated beneficiaries to retain donated assets

Disadvantages

- / Donor may be taxed on the trust's income
- / Donor loses control of the assets during the term of the charity's interest

Upon creation of the CLT, the donor is entitled to an income tax charitable deduction if the charitable interest is in the form of a fixed percentage of trust assets or a guaranteed annuity and if the donor will be taxed on the trust's annual income as it is earned (i.e., a grantor trust). If the donor establishes a nongrantor CLT, the donor will not receive a charitable income tax deduction but will not be taxed on the trust's income each year either.

Important gift tax and estate-planning objectives can be achieved through the use of a CLT. The transfer of property to a family member will result in a current gift for gift tax purposes or will trigger estate taxes at death. The gift or estate tax is reduced with a CLT because the value of the gift is reduced by the value of the income interest given to the charity. The value of the remainder interest passing to the family members can be engineered to produce significant transfer tax savings.

Special considerations

In many charitable structures, the donor must relinquish control of the assets being donated. If moving family assets outside of your control is not a step that makes you comfortable, then this option in an overall wealth management plan may not be for you.

Charitable structures can also add a complicated layer to your wealth management plan, and many of the options outlined here require careful planning and take time to create. This is another consideration if you're interested primarily in keeping your plan as simple as possible. Finally, charitable structures and wealth transfer often complement each other in an overall wealth management plan. Consider creating these elements alongside each other to increase their effectiveness.

Example: Paul and Martha place appreciated securities with a value of \$200,000 into a nongrantor charitable lead unitrust, which is to pay income for the funding of a scholarship at the private school their children attended. The payout is set at 8% of the annual value of the trust's assets for a term of 10 years. At the end of the 10 years, the remaining assets will pass to Paul and Martha's children. A taxable gift results at the time the trust is established, but the gift tax is significantly reduced by the value of the income interest given to the school. Instead of a \$200,000 gift, the income interest reduces the gift to approximately \$88,000. In addition, upon the deaths of Paul and Martha, there is no additional estate tax, and any appreciation in the securities after their transfer to the trust will not be subject to gift or estate taxation. (Note that there will be no permitted income tax charitable deduction because Paul and Martha set up the trust as a nongrantor trust and are not taxed on the trust's annual income.)

Another option presented to Paul and Martha included their grandchildren: If they made their grandchildren the remainder beneficiaries of the charitable lead unitrust, the transfer would be subject to the generation-skipping transfer tax. Paul and Martha could consider using some of their generation-skipping transfer tax exemption when they create the trust.

Misconceptions

As with all areas of tax planning, certain misconceptions surround charitable giving. For example, the concept of creating an income stream as part of an overall plan of charitable giving is often a source of confusion. Certain trusts and annuity arrangements can provide the opportunity to turn non-income-producing assets into a income stream for the donor while also obtaining a charitable deduction.

Many misconceptions also tend to surround the reality that not all gifts qualify for a charitable income tax deduction.

First and foremost, the donor must itemize deductions on the individual income tax return to qualify for the deduction. Further, contributions made to the following entities are not deductible:

- / Political action committees
- / Social and sports clubs
- / Chambers of commerce
- / Trade associations
- / Labor unions
- / Certain social welfare organizations
- / Most foreign charities (Interested donors should explore whether the foreign charity has a US affiliate—often referred to as a friends-of organization—as an alternative to receive a charitable deduction.)
- / Political parties
- / Organizations that engage primarily in lobbying activities
- / Other nonqualified organizations

In addition, no payments made for tuition; or for raffle, bingo, or lottery tickets; or for dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups are deductible as charitable contributions. Neither is the value of a volunteer's time or services or the value of blood given to a blood bank deductible as a charitable contribution.

Charitable organizations often hold special events for donor groups or to encourage additional contributions; some of the costs associated with them are deductible. Such fund-raising activities include lunches, dinners, formal banquets, concerts, golf tournaments, and shows. The charitable deduction substantiation requirements require the charity to disclose to its donors the deductible and nondeductible (value of goods and services received in return for attending the event) portions of any tickets or admission charges.

Another misconception about charitable giving involves which assets can be incorporated into a giving plan. It is important to remember that real estate and other property can be the primary contributions to a charitable giving plan, as can cash, stocks and securities.

Conclusion

The numerous options for crafting a charitable plan provide flexibility when you're selecting and tailoring a structure to meet your specific needs. Those options—coupled with the benefits to you, your family, and society—make charitable giving a unique aspect of an overall wealth management plan.

For a more detailed discussion on determining the deductibility of charitable contributions, visit pwc.com/pfs.

The examples presented herein highlighting the benefits that can be achieved by employing certain charitable strategies are meant to give directional guidance. As IRS and other prescribed rates required for these calculations change, results can differ. Please consult your tax or financial advisor for modeling with the most up-to-date rates.



Estate and gift planning

Wealth transfer planning enables you to protect your wealth and steward it into future generations. Although each individual's situation is unique, it is almost always appropriate to follow a four-step process in building an effective estate plan.



Most of us will likely spend a lot of time and effort working to accumulate enough wealth to live comfortably and, potentially, provide for our loved ones upon death. The purposes of an estate plan are to preserve that wealth and to ensure that it passes to our designated beneficiaries at the time and in the manner we choose.

There are many potential objectives both financial and nonfinancial to consider in the estate-planning process. Each person's objectives—and the relative weight the person places on each of them—are different as well as likely to change over time. In addition, there are many tax implications that should be carefully considered in the development of an estate plan, and the relevant tax rules change frequently.

For those reasons, the estate-planning process is always fluid, and any plan should be reevaluated periodically to be sure it reflects current objectives.

When is an estate plan appropriate?

Although the complexity of an estate plan can vary widely depending on individual circumstances, objectives, and family situation, you should have some form of estate plan if:

- / You have minor children.
- / You may become disabled in the future.
- / You are a business owner.
- / You have or will have an estate large enough to require the payment of estate taxes at death.
- / You want to be sure that specific assets or a specific amount of assets will pass to certain beneficiaries.
- / You want to leave property to a trust for beneficiaries instead of leaving property to beneficiaries outright—in order to have the property managed for the beneficiaries, or to delay or stagger the time when beneficiaries will receive the property, or to allow multiple beneficiaries or generations to benefit from the same assets.
- / You or your beneficiaries may need asset protection from future creditors.
- / You own property in more than one state.
- / You or your spouse is not a US citizen.

- / You are in a nontraditional relationship, and your immediate relatives are not your intended beneficiaries.

Nearly everyone falls into at least one of those categories, so it's almost always appropriate to have an estate plan. Failure to have an estate plan could result in:

- / Having the wrong people (i.e., people contrary to your intention) inherit your property
- / Having your property transferred in the incorrect form—for example, leaving property directly to a person who is uninterested in or incapable of handling property or, conversely, putting property in a trust where circumstances warrant giving the property directly to the beneficiary
- / Improper ownership (husband separately, wife separately, or some form of joint ownership) of assets, which can jeopardize the maximum use of tax exemptions or cause property to pass in a way that is contrary to your intention
- / Higher combined estate and gift taxes due to failure to take maximum advantage of available estate and gift tax exemptions, exclusions, deductions, and credits
- / Adverse impact on a family-owned business due to lack of a management succession plan
- / Having your children inherit a portion your estate that you intended to leave to your surviving spouse
- / Lengthy or emotionally painful court proceedings concerning the appointment of guardians for your children
- / The court appointment of a representative to make financial or health-care decisions for you in the event of your incapacity
- / Incurring higher-than-necessary administration expenses
- / Lack of liquidity from the forced sale of estate assets to pay expenses and taxes

Creation and operation

Although each situation is unique, estate planning generally follows a four-step process.

Step 1: Assess the current situation

The first step in any plan is to determine where you currently are: You need to know where you're starting from before you can develop a plan to get you to where you'd like to be. For estate-planning purposes, this includes reviewing your current financial situation, determining your goals and their relative importance, and analyzing any current wills, trusts, and other financial-planning documents.

For financial information purposes, it's useful to create an estate tax balance sheet. This includes the following:

- / Listing the types and locations of your assets
- / Determining the current ownership of each asset—whether the property is owned by you, your spouse, or jointly (and the type of joint ownership) or is community property. The form of ownership can dictate who receives the property upon death, so this is a critical part of the estate-planning process.
- / Reviewing the beneficiary designations on certain assets (life insurance policies, retirement plans, deferred compensation, etc.)
- / Evaluating the future appreciation potential for various assets. A major benefit of making lifetime gifts is that any appreciation in the property that is given away escapes estate and gift taxes, so identifying the appreciation potential of each asset is important.

Some of the most common objectives to consider as part of the estate-planning process are:

- / Maintaining your current standard of living and planning for your future standard of living
- / Providing for your surviving spouse and dependents
- / Naming guardians for your minor children
- / Designating someone to make financial and health-care decisions if you or your spouse becomes incapacitated
- / Maintaining control over your assets during your lifetime
- / Ensuring that your property is distributed according to your wishes. This

includes specifying who receives your property, the amount the recipient receives, and the form (outright or held in trust) in which the recipient receives it.

- / Making sure your property is transferred in an efficient, quick, and orderly manner
- / Protecting your assets from the claims of your creditors and the claims of your beneficiaries
- / Reducing the overall estate and gift tax liabilities associated with transferring your property, including reducing the value of assets that are subject to tax, deferring the payment of tax, and taking maximum advantage of available exclusions, exemptions, deductions, and credits
- / Preserving the value of and planning for management succession of your business
- / Minimizing nontax administration and transfer costs
- / Addressing liquidity needs both before and after death
- / Building into the plan a flexibility that is designed to take into account changes in circumstances

It's important to determine how important each of these objectives is to you. Finally, review your current wills, trusts, and other documents if any. This will reveal how property will be disposed of under your current plan or, if you have no current plan, how the government will dispose of your property.

At the end of the assessment stage, you should have (1) a clear understanding of your estate-planning goals and the relative weight that you place on each goal; (2) an estate tax balance sheet that lists your various assets by type, current ownership, current value, estimated future appreciation, and current beneficiary designations; and (3) an estate flowchart that illustrates how your estate will pass (assuming, alternatively, that you predecease your spouse and vice versa), according to your current documents and ownership structure. This would include the estimated estate tax due and a liquidity analysis to determine how the tax and other expenses will be paid.

Step 2: Identify alternative planning opportunities

Using the information from the assessment stage, you can begin to examine the estate-planning techniques that would be best suited to helping you meet your goals.

Following are some of the elements of an estate plan that most people should consider implementing. The first few techniques listed would benefit virtually everyone; they're followed by more-advanced estate-planning ideas.

Have a will, a health-care proxy, and a durable power of attorney drafted; and name guardians for your children

If you do not have a will, the law of your state of residence will generally determine who receives your property at death and how and when the individual or individuals receive the property. In many states, if you are married with children, not having a will means your surviving spouse will not receive all of your assets; instead, a portion will pass to your children. In addition, you will miss the opportunity to generate some significant estate tax savings for your family. Even when an estate is not large enough to require the payment of estate tax, a will assigns guardians for minor children and specifies who will receive assets and when.

It's also useful to draft a durable power of attorney and a health-care proxy. These documents specify who can make health-care and financial decisions for you in the event that you become incapacitated.

All three documents are important—and especially for those in nontraditional relationships and whose immediate relatives are neither their intended beneficiaries nor their intended decision makers.

Executor and trustee and designations

The executor will be in charge of administering the estate. The trustee(s) will be in charge of administering any trusts created during your lifetime. An important part of the estate-planning process is selection of the individuals who will serve in those roles (and the alternate individuals who will serve if those selected are unable or

unwilling to serve). Part of this process involves weighing the advantages and disadvantages of choosing family members or a professional adviser such as an attorney or a professional trustee or some combination thereof to serve in these roles.

Review how property is owned, and designate beneficiaries

Part of the estate-planning process involves evaluating whether you and your spouse each have enough property in your separate names to take full advantage of the estate, gift, and generation-skipping-transfer (GST) tax exemptions, exclusions, and credits that are available. A review of asset ownership can help determine whether lifetime gifts or transfers between you and your spouse should occur to ensure that you each have enough assets in your own names to take maximum advantage of your available tax exemptions. Failure to plan properly in this area can significantly increase overall tax liability.

If you're married, joint ownership with right of survivorship can defeat an otherwise excellent estate plan because the surviving spouse will automatically receive the property at the death of the first spouse. You may want the property to go to your children or to someone else. Owning the property in this manner may also leave you unable to fully utilize the estate tax exemption amounts allowed for both yourself and your spouse.

If you live in or used to live in a community property state, all property acquired during marriage while living in that state is generally treated as half owned by each spouse regardless of how it is titled. This can cause similar issues regarding passing the property to children or others and regarding your ability to fully utilize the estate tax exemption amounts allowed for both yourself and your spouse.

The recipients of several types of assets such as life insurance policies, retirement plans, and deferred compensation are determined by beneficiary designation, not by your will. It is important to review the beneficiary designations and the alternate

beneficiary designations on all of these assets. Failure to do so can result in adverse consequences, such as the wrong person receiving the asset, decreased flexibility in your plan, increased income tax liability, and increased estate tax liability due to failure to fully utilize exemption amounts or take maximum advantage of charitable bequests.

Consider the form and amount of property left to your spouse

For most married people, providing for the surviving spouse is a primary estate-planning goal. For both estate and gift tax purposes, there is an unlimited marital deduction for amounts transferred to a spouse, assuming the receiving spouse is a US citizen.

Wills should address how property is to pass to the surviving spouse. Generally, in order to qualify for the marital deduction, property must pass to the surviving spouse in one of three basic forms:

(1) outright, (2) via a general power of appointment trust, or (3) via a qualified terminable interest property trust.

Each of these methods of transferring property to a spouse has advantages and disadvantages, and an important part of the estate-planning process involves evaluation in order to determine the form that is best suited to meet your goals. These methods of making the marital bequest are not mutually exclusive; the total property passing to the surviving spouse may be divided, and different forms may be used for each part of the transfer.

Outright transfers to a surviving spouse qualify for the marital deduction. However, such transfers may give rise to concerns regarding control over the ultimate disposition of the property and effective financial management of the property. If the marital transfer is made by outright bequest, the first-to-die spouse will have no control over the ultimate disposition of the property. Such a concern may be particularly relevant in situations in which either spouse has children from a previous marriage or in which the surviving spouse remarries. Additionally, the surviving

spouse may be inexperienced in or lack the desire to become involved in the financial management of property.

Using a trust for marital transfer can help address concerns regarding the ultimate disposition and financial management of the property.

A transfer qualifies for the marital deduction if property is transferred to a general power of appointment trust—that is, a trust that (1) stipulates mandatory annual distribution of income to the spouse, (2) allows for discretionary distributions of principal to the spouse, and (3) provides that the surviving spouse can direct who receives the property upon that spouse's death. This arrangement may alleviate some of the concerns regarding financial management of the property. However, the first-to-die spouse will still have no control over ultimate disposition of the property. In some states, this type of trust is needed to qualify for the marital deduction.

A transfer also qualifies for the marital deduction if the property is transferred to a qualified terminable interest property trust. This is a trust that (1) stipulates mandatory annual distribution of income to the spouse, (2) allows for discretionary distributions of principal to the spouse, and (3) allows the first-to-die spouse to direct who will receive the remaining property upon the death of the surviving spouse. This arrangement may alleviate both the concerns regarding financial management of the property and the concerns regarding control over ultimate disposition of the property. However, this technique allows much less flexibility for changes in circumstances that may happen between the deaths of the spouses.

Utilize the estate tax exemption amount

Spouses are each entitled to an estate tax exemption amount of \$3.5 million (as of 2009), which shelters this amount from estate tax. As discussed earlier, if you leave all of your property to your spouse, then due to the marital deduction there will be no estate tax. However, your surviving spouse will not be allowed to

use your estate tax exemption. When the surviving spouse dies and passes the combined property to other beneficiaries, that spouse will be allowed to use his or her own estate tax exemption only to offset the estate tax, thereby wasting the exemption of the first-to-die spouse.

There are several ways to utilize the estate tax exemption of the first-to-die spouse that avoid this significant potential increase in overall estate tax: outright transfers to beneficiaries other than a spouse or charity, transfers to trusts that benefit both the spouse and other beneficiaries, and the potential use of disclaimers by the surviving spouse, among others. The tax implications of estate planning are discussed in further detail later.

Give lifetime gifts

Over time, an annual gifting program can remove hundreds of thousands of dollars from your estate on a tax-free basis. You can give up to \$13,000 (\$26,000 if you're married and your spouse joins in the gift) to each of any number of people annually without having to pay a gift tax (as of 2009).

Annual exclusion gifts remove property from your estate at no gift or estate tax cost and can shift income-earning property to family members in lower income tax brackets. This also removes from your estate any future appreciation in the value of the gifted property.

If the people to whom you would like to make gifts are minors to whom you do not want to make outright transfers, there are several alternative account and trust arrangements that will qualify you for the exclusion without making outright transfers.

In addition to the \$13,000 annual exclusion, there is an unlimited gift tax exclusion for any tuition paid directly to a school or for medical care payments made directly to a health-care provider on someone else's behalf. These tuition and medical payments are gift tax free and do not count against the annual gift tax exclusion. Tuition payments (but not room and board, books, or other expenses)

made directly to a private elementary school, secondary school, or college all generally qualify for this exclusion.

Gifts to a qualified tuition program, or 529 plans, do not qualify for the unlimited tuition gift tax break. However, there is a special rule that allows a contribution made to these plans in one year to be spread over five years. If done properly, it allows you to use five years of annual gift tax exclusions against a gift made in one year.

Additionally, you're also entitled to a \$1-million gift tax exemption; the first \$1 million of cumulative lifetime gifts is exempt from gift tax. The gift tax exemption amount used during a lifetime is subtracted from the estate tax exemption amount available at death. For example, a person dying in 2009 who has used all of the \$1-million gift tax exemption amount by making lifetime gifts will have an estate tax exemption amount of \$2.5 million (\$3.5 million minus the gift tax exemption used).

However, you may still want to make gifts up to the \$1-million exemption in order to remove future appreciation from your estate. For example, assume you have \$1 million that will grow to \$3 million by the time of your death. If you give the \$1 million now, you will use your \$1-million gift tax exemption and still have \$2.5 million of your estate tax exemption at the time of your death. If you keep the \$1 million until your death (when it will be worth \$3 million), then it will use \$3 million of your estate tax exemption, leaving you with only \$500,000.

Create a life insurance trust

The proceeds on a life insurance policy that you own on your life are subject to estate tax. To shelter these proceeds from estate tax, you can consider transferring existing policies into an irrevocable trust created for the purpose of holding the policy and managing or distributing the death benefit proceeds. A life insurance trust may also help address the liquidity needs of your estate. There are various options regarding the terms and beneficiaries of this type of trust.

An existing life insurance policy that is transferred to an irrevocable trust will not be effectively removed from your estate for a period of three years from the date of transfer.

For new policies, you should consider having the trust acquire the policy directly rather than receiving it from you or someone else. This may allow the death benefit proceeds to escape estate taxation immediately. (For more on life insurance, see chapter 8, “Insurance,” page 68.)

Create a grantor-retained annuity trust

To transfer the future appreciation of an asset to beneficiaries but retain the current value of the asset plus a fixed annual interest payment based on the asset’s current value, consider transferring the asset to a grantor-retained annuity trust (GRAT).

A GRAT allows you to retain the right to receive an annuity stream for a specified term of years that is equal to (1) the fair market value of the property at the time you create the trust plus (2) a fixed rate of interest. The fixed return over the entire annuity term is based on the prevailing interest rate (as published by the Internal Revenue Service [IRS]) for the month the GRAT is created. If the trust assets produce an actual economic rate of return exceeding the fixed return, the GRAT’s beneficiaries will receive the excess either in a further trust or outright and at little or no gift tax cost.

A GRAT works best with assets that are likely to appreciate rapidly. The higher the rate of return on trust assets, the greater the amount that will go to the GRAT beneficiaries gift tax free. Typical assets placed in this type of trust include closely held businesses, publicly traded stock, and other assets that are expected to grow quickly.

GRATs also work best when interest rates are low, because appreciation of assets above the benchmark rate of return (the interest rate published by the IRS for the month the trust is created)

passes to the beneficiaries. The lower the benchmark rate of return, the more the beneficiaries will receive.

While no changes to the GRAT rules have yet been made, legislators have recently been discussing making changes to them that would make them less beneficial. For this reason, and because interest rates are currently at relatively low levels, it may be wise to consider establishing a GRAT sooner rather than later.

Create a qualified personal residence trust

A personal residence—either a principal residence or vacation home—can be transferred to the beneficiaries of a qualified personal residence trust (QPRT) at a discount from the home’s current fair market value. The grantor can continue to live in that principal residence or vacation home for a specified term of years and continue to take a mortgage interest deduction as well as a real estate tax deduction. When the term interest in the trust ends, arrangements can then be made to rent the home from the trust or its beneficiaries at fair rental value. This is an excellent means to further reduce the estate.

A QPRT is especially desirable when (1) significant future appreciation is expected in the value of the home, because any appreciation that occurs after the trust is created can escape estate and gift tax, and (2) interest rates are higher, because a higher interest rate, which helps determine the value of your right to live in the home, will result in a lower gift tax value.

Create an intentionally defective irrevocable trust

The intentionally defective irrevocable trust (IDIT) is another technique that may allow transfers of the future appreciation in an asset to beneficiaries while keeping the current value of the asset plus a fixed annual interest payment based on the asset’s current value.

IDITs involve setting up a trust that is ignored for income tax purposes and then selling an asset to the trust in exchange for the trust’s promissory note. The terms of the promissory note require the trust to pay you (1) the fair market value of the property at the time you

sell the asset to the trust plus (2) a fixed rate of interest. The interest rate is based on the prevailing interest rate (as published by the IRS) for the month the sale occurs and also depends on the length of the note and the frequency (annually, semiannually, quarterly, etc.) that interest payments are required.

If the trust assets produce an actual economic rate of return that exceeds the specified interest rates, the IDIT's beneficiaries will receive the excess either in a further trust or outright and at little or no gift tax cost. Unlike GRATs, IDITs can also be effective for generation-skipping-transfer tax-planning purposes. (The various types of taxes that impact estate planning are discussed in more detail later.)

Like a GRAT, an IDIT works best with assets that are likely to appreciate rapidly. The higher the rate of return on trust assets, the greater the amount that will go to the IDIT beneficiaries gift tax free. Typical assets placed in this type of trust include closely held businesses, publicly traded stock, and other assets that are expected to grow quickly.

IDITs work best when interest rates are low, because appreciation in the assets above the interest rate on the note passes to the beneficiaries.

Additionally, although the IDIT will be the legal owner of the asset, you will remain liable for the income tax on the income earned by the trust. Why is this an appealing option? The income tax payment provides an income tax benefit for the trust beneficiaries, because what they receive from the trust will not be diminished by the income taxes owed by the trust, yet your payment of the income tax is not considered a gift to the trust. The "defective" aspect refers to the fact that the person setting up the trust remains liable for the income taxes of the trust.

Create a dynasty trust

The generation-skipping-transfer tax is imposed in addition to the estate or gift tax that is otherwise owed. You are

currently entitled to a GST exemption of \$3.5 million (as of 2009). A dynasty trust is designed to enable you to take maximum advantage of your GST exemption and is typically set up to last for the longest possible period allowed by law.

A dynasty trust can be established either during your life or in your will. This trust is designed to allow you to set aside assets for your grandchildren and future descendants (while still allowing for distributions to your children if necessary) without incurring gift, estate, or GST tax at each generation.

Create a charitable trust

A charitable trust can allow you to fulfill your charitable objectives while (1) still retaining an interest in your property or (2) giving an interest in the same property to other beneficiaries, such as children.

A charitable remainder trust allows you to transfer assets to a trust and to keep or give to others the right to receive an annual annuity payment for a specified number of years (or until your death). At the end of the term (the specified years or your death), the remaining assets go to charity.

A charitable lead trust essentially works in reverse: The charity is entitled to receive an annuity payment for a specified number of years, and at the end of the term the remaining assets are returned to you or given to the beneficiaries of your choosing.

These charitable trusts may allow you to (1) obtain a current charitable income tax deduction and (2) give property to charity while still retaining an interest in the property or giving such an interest to others. (For more detail on these and other charitable giving ideas, see chapter 3, "Charitable giving," page 24.)

Step 3: Implement the estate plan

Once the different alternatives have been evaluated, the next step is implementation. This includes having new documents drafted by an attorney and reviewing the documents to ensure their accuracy. It also includes producing (1) an estate tax

balance sheet that reflects the changes made and (2) a revised estate flowchart that illustrates how the estate will pass (assuming, alternatively, that you predecease your spouse and vice versa), according to the new plan. This would include the estimated estate tax due under the new plan and a liquidity analysis to determine how the tax and other expenses will be paid.

Step 4: Monitor the plan

The final step in the estate-planning process is to periodically review and monitor your plan. Over time, changes in your objectives or in their relative importance to you; changes in your personal situation, such as new children or grandchildren, marriages, divorces, deaths, your beneficiaries' personal situations, or your own financial situation; and changes in the tax law may necessitate changes to your plan. At those points, it is appropriate to start over again the estate-planning process—or some modified, shorter version of it—as described earlier.

Tax implications

As indicated throughout this discussion, taxes represent an important consideration in the estate-planning process. Federal transfer tax is imposed when a person transfers property to another at death (the estate tax) or during life (the gift tax). In addition to the estate tax or gift tax, a third tax—the generation-skipping transfer tax (GST)—is imposed on transfers during life or at death to grandchildren and younger recipients.

The federal estate tax is currently in a state of transition. As the law is now written, for people dying in 2009 the maximum federal estate tax rate is 45% and the first \$3.5 million of a person's estate is exempt from estate tax due to the estate tax exemption amount. The estate tax is currently scheduled to be repealed for one year for people dying in 2010. For people dying in 2011 and after, the maximum federal estate tax rate is scheduled to be 55% and the estate tax exemption amount is scheduled to be \$1 million.

Under current law, the highest gift tax rate for 2009 is 45% and the first \$1 million of lifetime gifts is exempt from gift tax. The gift tax is not scheduled to be repealed in 2010. In 2010 the highest gift tax rate is scheduled to be 35%, and the gift tax exemption amount is \$1 million. For gifts made in 2011 and after, the maximum federal gift tax rate is scheduled to be 55% and the gift tax exemption amount is scheduled to be \$1 million.

As discussed earlier, it is important to note that estate and gift taxes work in tandem as a unified transfer tax system. The gift tax exemption amount used during life is subtracted from the estate tax exemption amount available at death. For example, a person dying in 2009 who has used all of the \$1-million gift tax exemption amount by making lifetime gifts will have an estate tax exemption amount of \$2.5 million (\$3.5 million minus the gift tax exemption used).

For GST tax purposes (remember that the GST tax is imposed in addition to the estate or gift tax), the highest GST tax rates and GST exemption amounts are currently scheduled to be equal to the estate tax amounts given earlier (45% and \$3.5 million in 2009, repealed in 2010; and 55% and \$1 million—indexed for inflation—in 2011).

It is widely anticipated that legislation may be enacted toward the end of 2009 that will address this uncertainty—perhaps in the form of freezing the tax rates and exemption amounts at the 2009 levels given earlier. Whatever the outcome, this uncertainty and the relatively high tax rates make estate, gift, and GST planning an important part of the estate-planning process for many people, particularly at this point in time.

Conclusion

Stewarding your wealth into future generations is a cornerstone of effective wealth management. A well-considered, carefully implemented estate plan can be a complex undertaking, but it enables you to transfer your wealth successfully and effectively. For more on estate and gift planning strategies, visit pwc.com/pfs.



Business succession planning

A well-thought-out plan for business succession is a key component of overall business success. However, this process is often overlooked or mishandled. Following 10 key best practices increases the chances of success—both of the transition itself and of the business in the long term.

Family businesses are intensely personal enterprises. The ownership interests are concentrated within one or more families, but the business has many stakeholders, including the owners, the owners' family members, the employees, the suppliers, the customers, and others. The controlling or majority owner is typically very concerned about maintaining voting control, usually for the controlling owner's lifetime. The controlling owner also tends to be very involved in the operations of the business and is usually very private with respect to the financial results and other aspects of the business. Founding and operating a family business take a great deal of time and commitment, often requiring sacrifices by the entire family.

Common business succession mistakes

Because of the nature of family businesses, owners often make a series of mistakes that hinder the effective succession of the business. It's easy to understand the reasons behind the mistakes, but it's critical to avoid them.

The common mistakes include failure to:

- / Work on a succession plan
- / Identify a successor
- / Adequately train the successor
- / Actively resolve competition for the successor role
- / Employ leadership delegation and oversight
- / Distinguish between proper compensation and earnings distribution policies
- / Enable owners to dispose of their ownership stake in an orderly manner
- / Plan for transfer of the ownership of the business
- / Make lifetime transfers of ownership interests to save taxes
- / Communicate plans in a timely manner to key stakeholders

Often, people find it difficult to discuss issues related to illness, retirement, or death. Lack of time is another commonly cited factor. However, the reality is that a business owner's day-to-day activities are seldom more important than planning for the future success of the business. Business owners who fail to prioritize

succession planning put family members, employees, and others at considerable financial risk.

Since many business owners do not begin to plan for the succession of the business early enough, they fail to identify the person who will take over leadership of the business. This failure prevents critical planning that is essential for an orderly transition of the business. Often, there are multiple children in a business owner's family who want to be the successor when the current leader steps down, but to avoid conflict and to avoid disappointing the family members who will not be selected, the business owner postpones identification of the successor indefinitely.

If a successor is not identified, then that successor cannot become trained and be prepared for the leadership role. The key executives and other employees of the business operate in an environment of uncertainty. They are left to wonder what will happen and who will take control if the current leader dies prematurely or is otherwise unable to continue in the leadership role.

When multiple children in the business owner's family want to be the successor, the business owner makes a mistake by failing to resolve the competition. Family members do not get a chance to communicate with the decision maker and understand the decision maker's process of selecting a successor. This leads to resentment toward the eventual successor, as well as possible misperceptions and anger about why the successor was chosen.

Business owners usually maintain very close control and oversight over all aspects of the business; they tend to make all key decisions and to resist delegating this responsibility. This style of leadership adds to the anxiety concerning what will happen when the business owner is no longer around to lead the business. It also causes tremendous uncertainty and confusion about operations and about decision making when a successor eventually takes over.

Family business owners tend to ignore distinctions between paying compensation to family members who work in the business and paying dividends to family members who may have ownership stakes in the business. The business owner may want to treat equally all family members who work in the business, and the owner typically does that by paying each family member the same amount of compensation regardless of the job responsibility or the efforts put forth. The business owner also does not typically elect to make dividend-type distributions of earnings when family members have ownership interests in the business. Therefore, family members who do not work in the business may receive no current benefits from ownership interest. As a result, they may develop resentment toward family members who do work in the business and receive compensation that may be excessive relative to their job responsibilities.

If a business owner does not own 100% of the business entity or if lifetime transfers of ownership interests are made to family members or others, there should be an orderly means to transfer ownership interests. The ownership interests of family businesses are typically not publicly traded, so there is usually no market for selling them. In addition, the value of the ownership interests may be hard to determine. As a result, the owners of a family business may have few or no viable options to convert their ownership interests into cash, which can cause serious problems for an owner in need of cash.

Family business owners often fail to develop a plan for the eventual transfer of their ownership interests in the business. Their wills typically state that upon their death (or the death of their spouse, whichever is later), their assets, including their business ownership interests, are to be transferred to their children, often equally. Upon the business owner's death, the children who work in the business may be disappointed to learn that they are co-owners of the business with their siblings who do not work in the business. This can become another source of family strife.

By failing to develop a plan for the orderly transfer of the ownership interests of the business, the business owner loses the opportunity to save significant estate and inheritance taxes. Upon the death of the business owner (or the death of the spouse, whichever is later), substantial death taxes can be owed on the value of the business ownership interests. In addition, the amount owed can be the subject of a dispute with the taxing authorities, since the tax is based on the value of the business ownership interests on the date of death. The value of those interests on any given date might not be determined easily, and the taxpayer's estate and the taxing authorities often wind up in protracted disputes over the taxable value. Once the amount of tax has been determined, the next problem is finding the cash to pay the taxes owed. Death taxes can equal as much as 50% to 60% of the value of the business ownership interests, and failure to plan for that tax liability can necessitate sale of the business to raise the necessary funds.

One of the biggest mistakes made by family business owners is failure to communicate to their heirs and to other key stakeholders of the business their thoughts and plans related to the business. This mistake may stem from the belief that all of the elements of a plan should be decided and finalized before communication. Undoubtedly, business owners also avoid communicating when they know or suspect that their message will not be received as good news by some of the business's stakeholders; few business owners enjoy the thought of disappointing children who will not be named the successor, or disappointing nonfamily key executives who might disagree with the choice. So the business owner often engages in little or no communication with the business's stakeholders about succession plans. That course of action—or inaction—is consistent with the private tendencies of business owners. However, it causes a great deal of uncertainty and disappointment.

Business succession best practices

Most business owners make some or all of the mistakes discussed earlier. However, these mistakes can be avoided. While there is no way to ensure that a family business will successfully transition to a new owner or leader, there are several strategies that can increase the chances of success, both of the transition itself and of the business in the long term. The efforts should be undertaken as part of an ongoing process, not as a onetime succession-planning event.

Planning early

The importance of early planning cannot be overstated. It helps owners meet their stated objectives and facilitates the continuity of their businesses—for the benefit of all of the stakeholders.

- / Early planning results in lower taxes.
- / Early planning produces increased value for the next generation.
- / Succession plans with longer time horizons are inherently more flexible and usually have better outcomes.
- / Conflicting aspirations within a family regarding the details and timing of the business transition may be more easily addressed through active planning efforts.

Identifying the successor

Succession planning is not an event; it is a process. A critical starting point is identification of the individual who will be trained to run the business when the current leader steps down (either voluntarily or involuntarily). Many of the other aspects of a succession plan depend on this step; if a successor is not identified, then progress on the succession plan will stall.

Identification of a successor will give the key stakeholders a sense that planning for the future is under way, even if they disagree with the specific choice. This is far better than the speculation and uncertainty that arise when stakeholders are kept in the dark about what lies ahead for the business.

Adequately training the successor

Ideally, the chosen successor should have professional experience outside of the business. A child of the business owner who has spent all of the time working in the family business may not be a good choice for the successor role because that child may lack the perspective to deal with potential new issues. Indeed, many owners have found that when a family member leaves the family business to work elsewhere for a time, that family member returns with a much better chance of succeeding in the role of successor.

A business owner should actively participate in training the successor by permitting the successor to watch and learn how the business owner performs the day-to-day responsibilities. The successor should also be rotated through various roles within the organization to gain a better understanding of the entire business. During the training process, the successor should have opportunities to make mistakes and to learn from those mistakes. Finally, this training process should be visible enough to give the successor credibility in the eyes of the business's stakeholders.

Resolving competition for the successor role

If there are multiple candidates who want to be the successor, the business owner should take action to resolve the competition during his or her lifetime. The business owner must communicate intentions and allow the stakeholders a chance for discussion. If the other candidates for the successor role can engage in direct dialogue with the business owner about the process and the rationale around the decision, they are much more likely to accept and support the named successor.

Delegating leadership and oversight

Many business owners adopt a leadership model that is similar to a dictatorship. This may have worked well when the business was started and through its early growth years—and thus the owner may be reluctant to modify this approach. Even when the business is run as a corporate entity and state law mandates that a board

of directors be formed to oversee the business, many business owners typically form a board composed of themselves and a few close family members who are given no real voice at the table.

Instead, a business owner should delegate some of the decision-making authority to key executives, division heads, or other delegates. This can be challenging for an owner who has made all significant decisions historically, but the goal of a succession plan is to prepare for the transition to a different type of business dynamic. As a business grows, it must change. Not all of the significant decisions can be made by one person. If delegation of decision making does not occur, the continued growth and success of the business will be hindered.

A proper board of directors (or trustees) is an essential governing body that can provide business planning, guidance, and oversight. The members of the board of directors should not include the business owner's lawyer, accountant, or other individuals whom the business owner can easily consult with for a fee. Membership on the board of directors could include key insiders and an appropriate number of strategically chosen outsiders. The key insiders are individuals who have worked in the business for many years and have the knowledge and experience to assist in leading the business. They may be key executives with deep understanding of the business and the industry in which the business operates, but they should not be limited to the business owner's family members or friends. It's very important for businesses to include some outside board members; those members should be identified through a strategic search for executives who have particularly relevant expertise, knowledge, or experience.

Membership on the board of directors should be limited to a defined period of time that must be frequently renewed or terminated. Each member should be paid a reasonable fee for service, with reimbursement for the expenses of attending the meetings. Compensation should be

carefully considered; board members paid excessively may lack objectivity, while those paid too little may not approach their board role with the proper level of importance.

Distinguishing between compensation and distribution policies

A business must pay appropriate and competitive compensation to all of its employees, especially the employees who are family members of the business owner. It is very common for business owners to pay their family members a "salary" that is equal to the compensation amounts paid to other family members. This is done out of a strong desire on the part of the business owner to treat each family member equally. The problem is that family members who provide more valuable services may become resentful. Furthermore, paying compensation that is out of line with the market cannot be sustained over the long term. It's a much better practice to pay family members for their services whatever amounts of compensation are representative of the market value of their services.

To treat family members equally, business owners can give family members equity stakes in the business and pay dividend-type distributions with respect to these interests. This way, each family member can be given an equal equity interest in the business and receive equal distributions. Often, family business owners are reluctant to pay dividend-type distributions because in the early years of the business, they form the habit of reinvesting the excess earnings into the business to fuel continued growth.

The difference between compensation for services rendered and equity-oriented distributions is an important distinction that the business owner should recognize. Failing to recognize that distinction—and using compensation to equalize family members—is a mistake that grows more and more significant over time.

Enabling owners to dispose of ownership interests in an orderly manner

Every business with more than one owner should consider using a buy-sell agreement to describe the terms and the process for ensuring an orderly transfer of the ownership interests in the event of an owner's desire to sell or because of the disability, retirement, or death of an owner. There are two categories of buy-sell agreements: the redemption agreement and the cross-purchase agreement. Sometimes, a hybrid of the two types is used. Under a redemption agreement, the business entity purchases the selling owner's ownership interests by using its own cash or debt. In a cross-purchase arrangement, the selling owner sells its ownership interests to other owners, not the business entity. This gives the buying owner(s) an increase in the tax basis of the purchased ownership interests equal to the purchase price. This can reduce tax in the future when the ownership interests are subsequently sold. In many cases, there is not enough cash either at the entity level or held by other owners to fund the entire purchase. Life insurance is sometimes acquired on the owners' lives and is owned individually or by a partnership or trust, and the insurance proceeds can be used to fund the buyout, with any balance funded by the business entity through a redemption transaction.

Planning for the transfer of business interests

A critical part of succession planning is the development of a well-thought-out, written plan for the transfer of ownership interests in the business. A business owner is a steward of the business during his or her lifetime, but there will come a day when the ownership interests will be transferred to another party. Business owners sometimes don't like to think about this, and that leads them into the mistake of failing to have a plan. Most often, owners rely on a sort of default plan whereby the ownership interests are bequeathed to one or more recipients in the business owner's will. This may be a "plan," but it is usually far less than optimal.

Every year, business owners should contemplate the eventual transfer of their businesses, whether to family members, other shareholders, key employees, or a third party. If sale of the business is contemplated, owners must take into account the financial strength of the business, the financial position of a buyer, available sources of financing, collateral, guarantees, the tax consequences to both parties, and cash flow issues. The timing of a transfer is another critical consideration. To manage these various issues, owners should engage advisers who can help them make effective and timely decisions, and give them a detailed understanding of the sale process.

The business owner should have a written plan that answers multiple questions, some of which are:

- / Who should receive the ownership interests?
- / When should the ownership interests be transferred?
- / Should restrictions be placed on the transferred interests?
- / How should the transferee be permitted to deal with the ownership interests?
- / Will the planned transfer cause conflicts that should be anticipated and addressed?
- / What are the tax consequences of the planned transfer?

Thinking about and actively addressing those considerations will substantially increase the likelihood of a successful transfer of the ownership interests.

Making lifetime transfers to save taxes

From a financial perspective, it is often beneficial to transfer some or all of a business enterprise that is on the brink of rapid growth in value. Although at this stage a business owner may not have a clear picture of the future control and leadership of the business, that should not deter the owner from acting to save taxes. The practical truth is that there will never be an absolutely clear picture of future control and leadership. For the current owner to be able to maintain some degree

of control and security, an effective succession plan needs considerable flexibility so it will be able to deal with changing circumstances. Such flexibility means that the plan can involve different types of entity structures, trust arrangements, or other vehicles. And it is critical that the business owner act on this as early as possible.

Too often, consideration of succession planning for a family business focuses primarily on the tax consequences of the succession plan. While the tax aspects can be extremely important, the nontax aspects of succession planning are usually far more important to the long-term success of the business.

Typically, transferring business interests at death causes more estate tax than the amount of gift tax caused by lifetime transfers of the same business interests. This means that lifetime transfers can save substantial taxes. In addition, there are generally many opportunities to transfer ownership interests during the owner's lifetime while reducing gift taxes. Transfers can be structured to permit the business owner to retain control while making transfers of entity interests that save substantial transfer taxes. A number of lifetime transfer planning considerations should be modeled and evaluated as a part of a succession plan, including:

- / Recapitalizing the business into voting and nonvoting interests so that the nonvoting interests can be transferred during the business owner's lifetime to save taxes without relinquishing voting rights
- / Using valuation discounts to reduce the tax impact
- / Obtaining a valuation appraisal from a qualified appraiser to support the value that is reflected in lifetime transfers of business ownership interests
- / Selling ownership interests to intended transferees or to a trust for the benefit of the intended transferees, often in exchange for a note that provides interest for the seller
- / Using lifetime transfer tax exemptions to efficiently transfer business ownership interests without incurring gift tax

Communicating plans to key stakeholders

Once a succession plan has been formulated, the business owner must communicate it in a timely manner to the key stakeholders. Business owners tend to carefully guard their privacy—perhaps to avoid potential conflicts. The problem with that rationale is that it may be correct. Disclosure of the plans may cause conflicts among the stakeholders, but it will be easier to resolve those conflicts earlier rather than later, when the owner may no longer be available to help.

Business owners should hold regular family meetings—facilitated by competent professionals if necessary—to communicate the plans and seek necessary feedback. Feedback is necessary so that the business owner can focus the family members on the reasons for the plan and to help them understand it and accept it. The business owner should also meet with key executives of the business to communicate the succession plan to them. If the executives are given no communication about plans over a prolonged period of time, they will have a strong reason to consider leaving the business to seek a more secure future. Engaging a professional facilitator is a best practice because inevitably there will in turn be feedback and reactions that stakeholders may not be comfortable communicating directly to the business owner. If a facilitator is not involved to capture that feedback about the plan, the lack of communication usually becomes an obstacle to a successful business transition.


Conclusion

A successful leadership transition is the result of a lengthy and ongoing succession process, which must be carefully planned and executed. It cannot be done in a short period of time, as a onetime event. Although the scope of the process may seem intimidating, it can be managed by setting progressive milestones that can be achieved in small steps along the way to the ultimate goal.

A photograph of two men in business attire. The man on the right is wearing glasses and a striped tie, looking towards the man on the left. The man on the left is seen in profile, wearing glasses and a dark suit. The background is bright and out of focus.

Choosing entities for businesses/investments

Businesses and investments typically take one of five common entity forms, each of which has a different impact on a wide range of considerations, including taxes, liability protection, and financing and estate-planning options. Choice of entity is an important decision, which should be made carefully and be periodically reevaluated as conditions change.



As a new year approaches, many people start thinking about new business or investment ventures. Others, in the course of reviewing their tax and investment strategies at year-end, may find there are good reasons to reorganize all or some of the parts of their existing business and investment entities.

Selecting which form of entity a business or investment takes is a critical decision that involves many legal, practical, and tax matters. When making the decision, you should carefully evaluate the impact the selected structure will have on a wide range of considerations, including taxes, liability protection, financing options, and estate-planning options. Your choice of entity will determine which taxes you are liable for and to what extent; some entities allow losses from that entity to offset other income and thereby lower your overall tax bill, while others suspend those losses, providing no current (or, possibly, even no future) tax benefit. While one entity can provide liability protection, it may also result in double taxation. In addition, as laws change, entity decisions should be periodically reviewed so as to ensure that the entity chosen is still the most desirable option.

Creation and operation

There are five commonly used types of business entities, each of which comes with its own set of practical applications and considerations.

Sole proprietorship

This is the simplest form of doing business and requires few legal or tax formalities. Both income and expenses from the business are included in the proprietor's personal income tax return. However, the sole proprietorship entity does not shield the proprietor from the liabilities of the business, as it is not an actual legal entity separate from the proprietor.

C corporation

At the other end of the spectrum is the regular, or C, corporation, which is, in some ways, the most formal of the business entities. Virtually all large businesses, as well as many small ones, are organized as C corporations. These must observe such formalities as maintaining a board of directors, holding shareholder meetings, maintaining corporate minutes and other records, and receiving shareholder approval of major corporate decisions. The two most significant features of C corporations are limited liability and a double tax on earnings. As a separate legal entity, the liabilities incurred by a C corporation are generally not passed through to its owners. However, corporate earnings are subject to a potential double tax; that is, the corporation pays an initial tax on earnings, and shareholders then pay a separate tax on earnings when they're either distributed as dividends or distributed upon liquidation. Although this double tax is often cited as a reason not to conduct business as a C corporation, it is just one factor to consider. Careful planning can reduce the double tax and eliminate other disadvantages, while such factors as additional and greater tax deductions, a flexible tax year, reduced capital gains tax on the sale of certain stocks, no limits on who may be a shareholder, and the right to easily transfer ownership, may outweigh other considerations.

There are several pass-through entities that are not subject to double taxation. Unlike C corporations, these business entities generally do not pay tax at the entity level. Instead, items of income, gain, loss, deduction, and credit from the business "pass through" to the owners of the business, who report them directly on their individual tax returns. These entities are:

Partnership, either general or limited

A partnership is a separate legal entity formed by two or more owners. Unlike C corporations, which are subject to federal income tax on business profits, partnerships do not pay federal income tax. Instead, income and loss items pass through to the partners, who report them on their personal income tax returns. Partners are taxed on their allocable share of partnership income or loss, whether or not it is distributed. Generally, similar rules apply for state income tax purposes.

/ General partnership

A general partnership is composed of two or more partners who pursue a venture for joint profit. General partners are personally liable for partnership obligations. Their personal assets, along with capital contributions and partnership assets, are all available to satisfy partnership liabilities as well.

/ Limited partnership

A limited partnership is composed of at least one general partner and one or more than one limited partner. General partners are responsible for the active management of the limited partnership's activities; limited partners are generally prohibited from participation in day-to-day management decisions; they are merely investors. Limited partners are liable for partnership obligations only to the extent of cash and property they contribute to the limited partnership and recent distributions they receive from the limited partnership. General partners are personally liable for all limited partnership obligations.

Limited liability company

The greatest recent change in choice-of-entity alternatives has been the emergence of the limited liability company (LLC). LLCs are hybrid entities that combine features of partnerships and corporations. Unless those involved elect to be taxed as a corporation, an LLC with two or more members is treated as a partnership for federal income tax purposes. But like a corporation, an LLC protects its owners/members from personal liability for business debts. Because an LLC combines the beneficial characteristics of partnerships and corporations, it has quickly become the business entity of choice.

Today all 50 states and the District of Columbia have some form of limited liability statute. The federal check-the-box rules have further advanced the use of LLCs because they greatly simplify and add certainty to the federal income tax classification of LLCs. Simply put, these rules let a new business choose whether it wants to be taxed as a partnership or as a corporation. Because of the LLC's popularity, many business owners are seeking to use LLCs in conjunction with their existing operations. In some cases, converting other entities into an LLC form may be appropriate. Conversions are sometimes undertaken to limit the liabilities of the existing entity or maybe to increase the permissible number of owners of the business. In addition, an LLC may offer tax savings and better cash flow opportunities relative to a corporation. However, it's important to keep in mind that the conditions that make one type of entity more favorable today may not remain constant as state and federal laws change. In addition, there is a potential for a tax liability upon the conversion of one entity into a LLC.

S corporation

S corporations have historically been considered small business companies that elect special tax status. The major difference between a C corporation and an S corporation is that an S corporation's income is generally subject to a single level of tax. Income, whether or not distributed, is passed through to shareholders and included on their individual tax returns. The S corporation entity combines the business and legal characteristics of a corporation, including limited liability, with many aspects of partnership taxation but does not provide as much flexibility as an LLC. S corporations are subject to a number of restrictions, including a limit of 100 shareholders. S corporations require the same corporate formalities as C corporations, including articles of incorporation, directors' and shareholders' meetings, corporate minutes, and shareholder votes on major corporate decisions. Both new and existing corporations may elect S corporation status. Because conversions of existing corporations may give rise to potential tax liability, careful planning is needed.

The Small Business Job Protection Act of 1996 and subsequent law changes have greatly liberalized S corporation eligibility laws by increasing the permitted number of shareholders and the types of entities eligible to elect S status. Those changes have made S corporations more appealing, and many relatively large companies are now able to qualify to operate as S corporations. However, certain state S corporation requirements have not changed to conform to the federal laws' changes. Many states follow the federal example that exempts S corporations from tax at the entity level. Some states, notably California and New York, may recognize the pass-through nature of S corporations but still impose a tax at the entity level. Others do not recognize S status and treat S corporations operating in their jurisdictions as C corporations: the entity pays a corporate tax, and the shareholders pay individual taxes on dividends received from the corporation.

Overview comparison of entities

	C corporation	Partnership	LLC	S corporation
Liability	Limited to amounts invested and loaned	Unlimited for general partners	Limited to amounts invested and loaned	Limited to amounts invested and loaned
Double Taxation	Yes	No	No	No (except for some built-in gains and passive income)
Pass-through of profits and losses	No	Yes	Yes	Yes
Limitation on entity losses deductible by owners	None deductible	Net investment plus net income plus share of debt	Net investment plus net income plus share of debt	Net investment plus net income plus loans to corporations
Subject to passive activity loss rules	Only certain small C corporations	Yes	Yes	Yes
Tax rates	15% on first \$50,000, increasing to 34% over \$355,000 and 35% over \$10 million	Income taxed to owners at marginal tax rate	Income taxed to owners at marginal tax rate	Income taxed to owners at marginal tax rate
Special allocations	Possible if tracking stock is issued	Possible if substantial economic effect	Possible if substantial economic effect	No
Fiscal year	New corporations: any fiscal year. Existing corporations: fiscal year with business purpose; automatic change permitted in certain circumstances	May be the year-end of majority interest or principal partners. Alternatively, may be the tax year that provides the least aggregate tax deferral	May be the year-end of majority interest or principal partners. Alternatively, may be the tax year that provides the least aggregate tax deferral	May end up to three months earlier than the year-end of principal shareholders. May require a deposit
Tax-free fringe benefits to owners	Permitted	Limited	Limited	Limited
Public offering	Yes	Yes, but some difficulty	Yes, but some difficulty	No
Tax-free merger with corporations	Yes	Yes, under certain circumstances. Additionally, possible tax-free incorporation available	Yes, under certain circumstances. Additionally, possible tax-free incorporation available	Yes
Accumulated earnings tax	Yes	No	No	No
Personal holding company tax	Yes	No	No	No

Tax implications

Tax is one of the central considerations in the selection of which form of entity a business or investment will take. Several questions ought to be considered:

- / Are the principal owners in the highest tax bracket?
- / What types of owners are expected to participate?
- / Is it expected that the business will retain or will distribute most of its earnings?
- / Do the owners plan any special allocations of tax items?
- / Is the business generating, or expected to generate, either operating or capital losses?
- / Will the income or losses generated be derived from passive activity?
- / Should the business use a tax year different from that of its principal owners?
- / What impact will employment tax obligations have on the business?
- / Do owners need to limit their exposure to liabilities?
- / What state tax treatments are applicable?

For detailed discussions of each of these questions, visit pwc.com/pfs.

Special considerations

In any business or investment, you should consider not only the potential for economic reward but also the associated risks. Business entities provide varying levels of liability protection for their respective members and in some cases provide different levels of liability for different types of members. In addition, some entity choices require certain elections and requirements; and failing to consider these could cause serious problems. The problems could be as simple as missing a filing deadline (resulting in a small penalty) or as serious as missing an election

deadline (resulting in double taxation). Improperly chosen or established entities may even lead to unlimited personal liability in the event of a lawsuit. In addition, some mistakes may lead to a court's disregarding the entity's separate existence, which can also expose you to unlimited personal liability in a lawsuit.

Furthermore, certain entities may be more appropriate than others if owners plan to exchange cash or property for an interest in the venture, or if they plan to contribute or distribute appreciated property. Such factors as number of owners; financing needs; potential for mergers, acquisitions, and divisions; likelihood of joint ventures; and compensation of owner-employees must be taken into account when selecting an entity. Finally, the various business forms present different advantages and disadvantages in the context of estate planning. Those implications should be carefully considered in the choice of an entity for a business or investment you intend to include in your estate and wealth transfer planning.

Conclusion

The choice of which form of entity a business or investment will take may have wide-ranging impacts in such areas as taxes, liability protection, and estate planning. The decision should be made only after those considerations have been carefully evaluated. Additionally, the forms of existing entities should be periodically revisited, as laws and other circumstances change, to ensure that the chosen entity remains the most appropriate option.



Family limited partnerships

A family partnership is a separate business entity established to manage a family's assets and investments. The family partnership can be an excellent way to control, grow, and transfer wealth to future generations while taking advantage of sophisticated investment attributes available to large investment pools.



A family partnership is similar to a family investment club. Like all investment clubs, the goal is to create a centralized mechanism for managing and controlling investments. The more sophisticated the investment categories and the larger the investment pool, the more important the partnership investment mechanism becomes.

A family partnership often takes the form of a limited liability company (LLC), which is treated as a partnership for tax purposes. Some advisers insist on the limited partnership form (often referred to as a family limited partnership), but either way, family partnerships must be registered with the state and are required to make periodic filings and pay periodic fees. There are several reasons for creating a family partnership.

Real estate

The original purpose of the family partnership was to provide a mechanism to transfer real estate to family members. It's very difficult to divide real estate into smaller units, and multiple-owner real estate presents a variety of problems, especially when the real estate is to be sold. The solution was the creation of the family real estate partnership, which allows the partnership to own the real estate and the family to divide the partnership units among themselves. This facilitates central control and easy transfer of land interests.

Investment partnership

The same economies of scale that apply to big endowments, pension plans, and mutual fund complexes can be applied to family partnerships. The fees and expenses of running an investment pool decrease as a percentage of assets as the size of the pool increases. Large investment pools can obtain discounted adviser fees, which decrease based on larger amounts under management. A

larger investment pool makes it easier to reach certain manager-imposed minimum investment amounts. Finally, many so-called alternative investments such as hedge funds and private equity funds must adhere to special qualification rules of the US Securities and Exchange Commission (SEC) for so-called sophisticated investors. Large investment pools also make it easy to meet those SEC qualification requirements.

The family partnership often contains mutual funds, separate investment accounts, and partnership investments in specialty funds. As a family partnership grows more sophisticated, it starts to resemble a hedge fund or private equity fund. Each portfolio represents a different asset class or style. Family members or their trusts can then choose to participate in a variety of different underlying portfolios. Each partner is free to choose how personal funds get invested—much like each participant in a 401(k) plan is.

Partnership or LLC units make excellent items for annual giving programs directly to family members, to trusts for their benefit, or to more-sophisticated trust arrangements such as grantor-retained annuity trusts and grantor trusts. It is possible for the senior family members to remain as partnership managers and still have some degree of control.

An ancillary benefit to the family investment club is the exposure to multiple types of investments for younger family members. It can become an important step in the investment education process. Likewise, it allows small investment amounts to participate in sophisticated strategies not normally available. This is an important benefit when making annual gifts to children, grandchildren, or trusts. Normally, the annual \$13,000-per-year gift could never attain a sophisticated investment allocation absent the family investment club, also known as the family partnership.

Example: Six siblings have insurance on their elderly parents toward expected estate taxes. When their parents die, the estate tax ends up being less than expected due to a downturn in business, so each of the children has approximately \$8 million to reinvest. The siblings realize they can pool their money to create a sophisticated investment fund, but they want to take into account that each of them has a slightly different view of what to invest in and how. As a result, they set up an investment LLC with special investment allocation rules based on each one's predetermined investment choices and with special rules about withdrawals and additions. The result is a family partnership allowing each sibling to make individual investment choices based on personal goals, with the freedom to remove funds within the rules the group established. Recently, one of the siblings took out \$1 million to build a home in the Caribbean—making this a wealth management option yielding many positive outcomes.

Asset protection

Finally, there is a level of asset protection associated with family partnerships. The partnership unit ownership can be restricted to family membership or to trusts for family members. If a partnership unit gets into general circulation due to, say, divorce or attachment by creditors, the partnership cannot be forced to distribute assets or liquidate. That inability to turn partnership units into cash makes them unappealing in a divorce or legal settlement of liabilities.

Creditors are looking for assets they can take and sell. Partnership or LLC units are not popular with creditors because under most state laws, creditors can force neither the sale of the partnership unit, nor distributions from the partnership, nor dissolution of the partnership. When a

creditor does get involved with a family partnership, it is typically limited to obtaining a charging order, which puts it into the shoes of the partner; that is, the creditor has all of the rights—and restrictions—associated with the partner while not actually becoming a partner.

Creation and operation

The most important feature of the partnership application process is the name chosen to identify the partnership. In many respects, naming the partnership can be as important as naming a child. The partnership name will appear on various tax filings, investment company account statements, and a variety of standardized forms. Thus, the name must be short enough to fit on standard forms yet specific enough to be readily identified by the partners.

There is a school of thought that suggests that a partnership name not contain the family name or the word *Family*. The rationale is that a partnership name is less likely to attract attention from creditors, the Internal Revenue Service (IRS), or any other official entity if it has a nondescript name. In any event, under most state laws, the name must contain a reference to the limited partnership or limited liability company designation. It is suggested that a family partnership choose either a short name or some initials that can be easily recognized by family members and extended family members and that it avoid trademarked names or takeoffs on trademarks. Some examples of good family partnership names are *M&D Ventures Ltd.* and *Oak Ltd.* and *Sandy Quay LLC*.

Once the family partnership has been created, the next step is to transfer assets into the partnership name. Depending on the type of assets, such title transfer is accomplished in a variety of ways. This is when the choice of partnership name

becomes a practical issue; that is, will the name fit on standardized forms? Once the name has been set, the partnership determines which assets will be included. Some examples follow.

Real estate

Real estate title transfers are accomplished by deed. The current owner signs a deed transferring the real estate to the partnership. And it is the general partner or managing member who has signature authority on behalf of the partnership. (Note that in many states real estate title transfer may trigger real estate transfer tax.) To protect the partnership, the deed should be recorded in the manner for recording deeds in the state, county, or locality. In addition, remember that there may be property, casualty, or liability policies associated with the real estate and that those policies should be adjusted to reflect the ownership of the real estate.

Cash accounts and traded securities

The partnership will normally need a bank account. Further, the partnership may have investment accounts with banks, brokerage firms, investment managers, or mutual funds. All of these accounts require transfers from their existing accounts and to an account in the name of the partnership. The managing partner is the person who will have signature authority over the new accounts. The managing partner will have to complete the necessary forms (which vary by broker, mutual fund, or bank) to make the transfer and so indicate in signing as the managing partner—for example, *John Doe, managing member for Oak Partners LLC*.

Business interests

If the family limited partnership is to own other business interests, then the ownership of the business entity must be retitled in the name of the partnership. Untraded (privately held) corporate stock would require the cancellation of old certificates and the issuance of new certificates. Likewise, partnership units (general or limited) or LLC units would require some written transfer form and recordation.

Partnership agreement

The partnership agreement (or limited liability company operating agreement) contains the list of instructions for running the partnership and for determining how the different partners share in distributions. The agreement also states what activities will be carried on and when the partnership terminates.

Tax attributes

Because the limited partnership and limited liability company are special aspects of tax law, careful drafting is required for the entity to be treated as a partnership for tax purposes. So while many of the partnership provisions are relatively standard, certain care must be taken in determining partnership termination events and unit transfers. The advent of the check-the-box choice for income tax purposes has removed some, but not all, of the pitfalls associated with the tax designation and the need for special provisions to accomplish tax characterization.

Death provisions

A major issue for the partnership is its continued management after the death of the controlling parental generation. Although the partnership can call for the reformation and continuation of the partnership, the death of the managing partner can create a window of opportunity for disgruntled limited partners to dissolve the partnership. Ideally, a successor to the managing partner should be identified so that the partnership can continue (if so desired). This is an issue that should be carefully considered with your advisers in creating the partnership and in determining whether to transfer units directly to children and grandchildren or, instead, to trusts for their benefit. These issues can be addressed by making the managing partner an entity rather than a person. For example, the managing partner could be a corporation or a limited liability company.

Transferability

Another important part of the partnership agreement is the language that places restrictions on the transfer of partnership units. Usually, units cannot be transferred

to anyone other than family members or to trusts for family members. The goal is to control the ownership of the units and limit those who could be partners. Special Internal Revenue Code valuation rules apply to partnerships and limited liability companies that have unusually restrictive provisions on termination events and unit transfers. Thus, including a variety of restrictions may not necessarily alter the valuation of units for gift or estate tax purposes, although such restrictions would certainly alter the legal results.

Departure

In the drafting of the partnership (or operating) agreement, careful consideration should be given to providing a mechanism for the departure of a partner or an LLC member. Depending on the circumstances, it may be desirable to adjust the departure payment in some fashion. In other words, withdrawal or departure in certain circumstances might lead to receiving a reduced price from the partnership, while other circumstances might lead to a fairer price. Such considerations as death, divorce, bankruptcy, and disability should all be part of the planning process.

There is also a school of thought that suggests it is appropriate to create economic barriers for withdrawal of a partner without the general partner's (parental generation's) consent. Such penalty provisions are designed to punish wayward children or dissuade divorcing in-laws.

Termination

The partnership agreement or limited liability company operating agreement will contain special provisions dealing with the events or dates that will automatically terminate the partnership. Such events include but are not limited to the death or bankruptcy of a partner, the votes of a majority of the partners, or about 20 to 30 years into the partnership's existence. The partnership can call for the reformation of the partnership if all partners or limited liability company members agree—meaning, the partnership can continue after a brief hiatus following the event.

One of the concerns for the parental generation is a hiatus in partnership activities (a technical termination and reformation of the partnership). It is during a hiatus that central control may no longer be present, and so, depending on whether the temporary loss of control is an issue, additional safeguards in the form of trusts that own partnership units may be needed.

It is also possible for a limited-partner revolt to prematurely terminate the partnership. A limited-partner revolt takes place when a group of limited partners (the required percentage varies by state) bands together to oust the general partner and take control of the partnership. Although this is not likely in a family setting, those with large or extended families may wish to consider this possibility during the planning activities.

Tax implications

A partnership is a legal entity but is not a taxpaying entity. In other words, the partnership pays no income tax. Instead, all items of partnership income are reported and subject to income tax on the individual income tax returns of the partners.

A partnership tax return (Form 1065) is required annually if the partnership had any items of income, incurred any expenditures treated as deductions, or incurred credits for federal income tax purposes. Thus, on one hand, a family partnership that owns real estate is required to file a partnership return in order to report the real-estate-taxes-paid expenditure. On the other hand, a partnership that owns only life insurance may not be required to file a partnership tax return, since premium payments are not deductible for federal income tax purposes.

Formation and property contribution

Special rules apply to appreciated property contributed to the partnership. The contribution of assets to a partnership is generally not a taxable event. However, a taxable event can arise if the partnership contains mostly securities (greater than 80%) and if the various partners contribute

various types of securities. While with advance planning any income tax difficulties at formation and contribution can be mitigated, note that there may be gift tax complications if property is later contributed to the partnership by the parental generation (without a corresponding increase in partnership units).

Annual partnership income and expense allocations

Generally, the individual partners report their pro rata shares of income and expenses each year. Only in very sophisticated investment partnerships will it be necessary for special allocations of income and expenses. Special income allocations and expense allocations can be counterproductive for gift or estate-planning purposes absent special investment allocations.

Although it is possible to have a variety of special sharing agreements concerning income, expenses, gains on sale, and gains in excess of certain minimums, within the partnership agreement such types of provisions are necessary only when different partners choose different investments within the partnership—much like a 401(k) plan.

Partner's capital accounts and basis

Part of the partnership tax return preparation process involves tracking and calculating a partner's capital account. The partner's capital account reflects the partnership's basis in its assets (so-called inside basis). The capital account can, but does not always, reflect the partner's tax basis or cost in that partner's partnership interest—so-called outside basis.

The issue of inside basis and outside basis (cost) is normally not a concern except after the death of a partner or on the sale of a partner's interest. It is at that point that the inside and outside basis figures diverge. Once the basis figures diverge, careful tracking of both inside and outside bases is critical to determine gain or loss on asset dispositions by the partnership as well as sales of partnership units from one family member to another.

Basis step-up at death

At death, the basis of a partner's interest in the partnership (outside basis) is stepped up to the date-of-death value. However, the basis of the assets owned by the partnership (inside basis) is not stepped up at the death of a partner or on the transfer of a partnership unit unless the partnership makes a special election. Once the election is made, the basis step-up in assets owned by the partnership applies only to the specific partnership units subject to transfer and not to the units of other partners. At this point several levels of basis tracking are required, as is special sharing of certain expenses, including depreciation expenses. Because this basis step-up election creates certain bookkeeping difficulties, some partnerships will not make the election.

Partnership dissolution

Generally, dissolution of the partnership is not a taxable event. Partners can receive assets without triggering income tax, although special rules apply for basis-tracking purposes.

Special rules also apply to partnerships that have not been in existence for at least seven years. These special rules are designed to capture sales and exchanges that are disguised as a partnership formation and dissolution. With minimal advance planning, these special rules (and their adverse income tax consequences) can be mitigated.

Gifts of units

Gifts of limited or general partnership units are gifts for gift tax purposes. Likewise, transfers of LLC units are gifts for gift tax purposes. The value of the transfer, combined with other gifts, should be examined to determine whether a gift tax return is required.

Additional contributions of property

If additional property is contributed to the partnership after formation, the party making the additional contribution will have made a gift to the other partners unless the party making the transfer receives additional partnership units based on the then value of the partnership.

Areas of controversy

Because family partnerships are often involved in sophisticated estate-planning arrangements, they are routinely scrutinized by the IRS. When the IRS is involved, the biggest area of controversy is typically whether the value of a partnership unit should be discounted for gift or estate tax purposes; if the IRS can invalidate the partnership, the discount related to the partnership is removed. (The same features that make family partnerships unappealing in the case of divorce or legal liability suggest that they should be discounted for other purposes.)

The IRS tends to concentrate on partnerships that are operated in a sloppy manner or on ones whose family members need constant distributions for living expenses. Such IRS scrutiny has in turn created a relatively large body of court cases, but the learnings from them can be enlisted to create a series of best practices and danger points to consider. Even within the adviser community there is some disagreement on these points, so consider them in light of your individual family circumstances.

Respecting the partnership and distributions for living expenses

One of the major danger points is the use of constant partnership distributions for living expenses or the placement of a personal home into the partnership. Either of those is potentially fatal to any type of estate planning, and they have resulted in the full value of partnership assets being included in the donor's estate. The court cases in this area contain language discussing the retained interest in the partnership assets as the reason for estate-planning failure. The constant distributions suggest that the assets are "owned" by the creator of the partnership.

General-partner or managing-member control

The adviser community is split over the concept of retained interest in partnership assets and how to interpret the court cases in which partnerships make distributions for living expenses. Many advisers say the parental generation can maintain managing-member status as

long as it respects the partnership structure and does not take constant distributions. However, another school of thought maintains that the parental generation must give up all control over the assets, meaning that someone else must be the managing member.

Who creates the partnership

The family partnership can be created by the parental generation. The parental generation can then give out units to family members or trusts as appropriate. However, some advisers insist that multiple family members pool their money to begin the partnership, even if some members must get their funds from gifts. But with multiple-party creation of a partnership, there is the potential to trigger income tax at formation depending on what assets get contributed. The potential for gain on formation is zero if at the start the parental generation alone contributes all of the assets.

Timing of transfers

Another area of controversy involves how long to hold partnership units before transferring them. The order in which activities take place is critical to the partnership formation process. The IRS has had some success when partnership units were transferred before the partnership actually owned any assets and when the assets were transferred before the partnership was even created. Such sloppiness not only is embarrassing for professional advisers but also suggests that a different type of transaction took place.

Special considerations

A large-scale family partnership can offer family members the right to add or remove funds from the partnership at staged intervals. Likewise, a large-scale partnership could allow family members to revise their investment allocations at staged intervals. Such activities give the family great flexibility in controlling this portion of its financial strategy. However, these same activities require sophisticated—often significantly expensive—bookkeeping capabilities, to the point where a

large-scale partnership may end up licensing special software from the same vendors that serve large mutual fund complexes and hedge funds. Before offering partners the rights to add, withdraw, and rearrange funds within the partnership, the family should consider the added bookkeeping costs associated with those freedoms.

Special considerations should also be noted if the ownership and control of a partnership lie with an elderly family member. If ownership can be 100% credited to a deceased partner, there are tax implications.

Example: A family had an established partnership that had been set up by Mike, a now elderly parent with a court-appointed guardian. The guardian set up an LLC partnership with approximately \$8 million and began distributing large portions of the partnership in \$20,000 amounts. The probate court had to approve creation of that LLC and the distribution strategy, mainly with the intent of protecting Mike's interest as head of the partnership. Regarding Mike's access to funds, the court transcript contained numerous questions indicating he could access as much of the funds whenever he needed to. When Mike died, he owned 60% of the partnership/LLC, but 100% of it ended up being included in his estate because he had never given up control. The information presented in the probate court approval process regarding his access to the partnership/LLC funds became evidence that turned this into a failed family partnership.

When are family partnerships not appropriate?

Family partnerships are not for every family. They require some level of attention (bookkeeping, tax filings, and management meetings); and failure to respect the partnership form or to file the appropriate forms can lead to petty annoyances or loss of expected estate-planning results. Other reasons a family partnership may not be a good fit are as follows.

- / There are a number of assets that should not be contributed to a family partnership, such as primary residences (which often create IRS issues over retained control and use), annuities, and ownership of S corporation stock. Transfer of these creates significant income tax problems such as loss of tax deferral and termination of S corporation status.
- / Family partnerships are designed to be long-term investments. They should not be making distributions for living expenses, because such partnerships are expected to distribute funds so the partners can pay income taxes. When creating the partnership, the family members should retain sufficient assets to take care of their regular living expenses and should not call on partnership assets for that purpose. Partnerships can make distributions for unusual events, but those should be kept to a minimum.
- / Family partnerships created by the elderly and infirm are subject to IRS scrutiny, because they give the appearance of manufactured discounts for last-minute estate planning. If the arrangement is rushed, many of the mundane details can get missed, such as improper titling of assets or not waiting for agreements and other formal documents to be finalized. It is these types of cases that give family partnerships a bad name.

Conclusion

A family partnership requires some tending but is an excellent way to control and grow wealth. The family partnership is a separate business entity that can hold titles to assets, collect income and gains, pay expenses, and file tax returns. The family partnership is also useful in the transfer of wealth, because making gifts of partnership units to children, grandchildren, or trusts for their benefit allows the passage of family wealth without losing any of the sophisticated investment attributes available to large investment pools.

Example: Anne has \$15 million in stocks and bonds after taking the family's private company public. She had a daughter, June, and a son, Eric, who still worked at the company, and she wanted to help them set up savings and investment accounts. So, Anne created a family partnership (using her pet names for the children in the title) and funded it with \$2 million. She then made a gift of the partnership to June and Eric and also made gifts of the public company stock to them and her four grandchildren. After a number of years, June and Eric had majority ownership of

their investment partnership. Fast-forward a few years, and the now public company was bought out for cash, which spurred significant funds through Anne's gift of company stock for the children and grandchildren. As a result, June and Eric decided to disband their partnership and to create two new family partnerships by pooling the funds they and their children had—all of which stemmed from their mother's initial gifts. Anne enjoys watching the effects of her partnership as the assets continue to grow and develop along with the size of her family.



Insurance

Insurance is a critical tool in preserving both your health and your wealth, and being properly insured is a fundamental part of a sound wealth-management strategy. Insurance should be considered in several areas, including medical and disability, property and casualty, life, and liability.



No matter how careful you are, life can bring unpleasant surprises: accidents, illnesses, fires, natural disasters, and others. And while you don't know whether or when any of those events may occur, they can have enormous impact on your greatest assets: your family's health and wealth. As a result, it is critical to incorporate risk management into your financial plan and to consider insurance in several areas, including medical and disability, property and casualty, life, and liability. In light of the economic events of the recent past, you should be sure to examine the financial strength of your insurance carrier, because you can no longer take for granted any particular insurance company's ability to pay claims.

Creation and operation

Having insurance is a fundamental part of a sound financial strategy, but the specific types of insurance you choose will be determined by your personal needs, preferences, and comfort levels.

Long-term-care insurance

Medicare generally does not pay the nonmedical costs of retirement homes, of custodial care, or of home care for the elderly. This is where long-term-care insurance can be of assistance.

Whether or not to purchase long-term-care insurance is an intensely personal decision because it involves protecting assets for children and grandchildren. Long-term-care insurance is generally not recommended for those with high net worth (who can self-insure), but it is recommended for those of moderate wealth.

When shopping for a policy, consider the following questions:

How much protection, or so-called daily benefit, does the policy provide?

You will need to estimate anticipated future costs, as well as how much you're willing to provide out of pocket.

Does the policy contain inflation protection?

It should, but with an increased premium.

How soon after admission to a nursing home or after an event do benefits begin?

Generally, longer waiting periods mean lower premiums. However, if the beneficiary dies during the waiting period, the policy pays no benefits.

How many years of benefits are covered?

Some policies contain at least one year of coverage; most policies provide as much as four or five years. Some states waive Medicaid asset limitations if they have long-term-care insurance providing a minimum level of coverage.

Depending on your specific needs, you may also want to consider the following questions: *Is custodial care covered? Is home care covered? Does the policy have restrictive provisions on preexisting conditions or exclusions? Is the right to renew guaranteed for life?*

Disability insurance

Disability insurance replaces your earnings while you are unable to work. The standard replacement level is 60% to 70% of gross earnings. The key features of a disability policy are the definition of disability, the level of coverage, cost-of-living adjustments, waiting periods, and earnings caps.

Disability benefits are taxable if the insurance premiums are deducted by or are paid for by an employer. Disability benefits are income tax free if the premiums are not deducted or if the employee treats the premiums as wages. Generally, high-income individuals should not deduct the premiums—or they should make sure the premiums are included in their wages in order to minimize the tax impact of any benefits received.

It's important that the definition of disability be job specific rather than general. In other words, it is your current job that you cannot perform—not just any job. Often, the job-specific definition applies to the first several years and is followed by a general disability description.

Another factor in disability insurance is that the longer the waiting period, the lower the premium. Likewise, the addition of a cost-of-living feature increases the premium.

Health insurance

The rising level of health-care costs is no secret. The federal and state governments are taking steps to make sure that everyone has some level of coverage, but you should be proactive in ensuring that you have the health insurance that best fits your needs. For example, you may want to take advantage of certain optional health plan features as part of your coverage:

Flexible spending account (FSA)

This is an employer-sponsored savings arrangement for medical care costs. The costs are typically funded annually. The advantage of an FSA is that the contributions are made on a pretax basis. The disadvantage is that if you do not spend all of the funds set aside, they revert to your employer. In other words, “Use it or lose it.” When funding an FSA, estimate the out-of-pocket costs you expect to incur during the next year—such as for co-pays or eyeglasses—and then arrange for that estimated amount to be withheld from your wages. Flexible spending arrangements are not available to partners in partnerships or to shareholders in S corporations.

Health savings account (HSA)

This is a special account connected to high-deductible medical plans. Contributions to an HSA account are tax deductible. Distributions from an HSA account are income tax free as long as they’re used for medical expenses. Because an HSA account can continue for long periods of time, the best strategy is to leave the HSA account alone as long as possible and pay current medical expenses with other funds. This allows the HSA account to accumulate earnings tax free that can be used later in life (after retirement). Health savings accounts are available to partners in partnerships and to shareholders in S corporations.

Property and casualty insurance

Property and casualty insurance includes home owner’s insurance, auto insurance, boat insurance, and airplane insurance. Special rules apply to each type of coverage, and some states regulate auto insurance rates and coverage. It’s important to find a well-respected agent to

guide you through the process and help you price different coverages. Often, discounts are available for combining coverages with one carrier.

In all cases, you should carefully evaluate the policy deductible. You may be able to significantly decrease the cost of coverage by increasing the deductible (a form of self-insurance).

Important considerations for home owner’s insurance include the following:

- / Maintaining replacement cost coverage or a minimum of 80% replacement coverage on the dwelling; this is important for full coverage on partial losses.
- / Maintaining replacement cost coverage for personal items
- / Obtaining riders for special property such as art, jewelry, cameras, and electronics
- / Maintaining minimum levels of liability coverage

Important considerations for automobile coverage include the following:

- / Maintaining minimum levels of liability coverage
- / Uninsured-motorist and underinsured-motorist coverage; this coverage protects you against the irresponsible behavior of others.
- / Special discounts for antitheft devices (especially window etching)

We live in a litigious world in which large judgments are sometimes awarded for injuries, real or imagined. An umbrella policy provides liability coverage in addition to regular home owner’s or auto insurance. You should probably purchase the maximum amount of coverage (premiums are relatively low for this coverage). Make sure to coordinate coverage with your home owner’s, auto, and boat policies.

For airplane coverage, the key considerations are the ownership and use of the plane. Special Federal Aviation Administration rules apply to airplane use, and the liability coverage associated with airplanes is often linked to specific planned use as defined by the agency. Be especially careful about insuring aircraft that are used in mixed business and personal activities. Also consider what entity owns the aircraft; the simple connection of an aircraft to a limited liability company can invalidate liability coverage.

Issues related to where you reside

Make sure you consider flood insurance or earthquake insurance if you live in a floodplain (a special flood hazard area) or an area prone to earthquakes.

Life insurance

There are a wide variety of life insurance products. Insurance carriers continue to add, delete, and change policy features to meet the demands of a competitive environment, and as a result, there are no comprehensive sources for life insurance comparisons, investment performance, or fee structures—as there are for mutual funds. However, life insurance is an important component of an individual's overall financial plan, particularly for estate tax-planning purposes in terms of amount of coverage, ownership of policy, and designated beneficiary.

In the purchase of life insurance, it's important to consider the following questions:

What is the purpose of having the insurance?

Is it to insure the family breadwinner? pay off debts at death? pay estate taxes? gain protection in transitioning a business? Or is the insurance a form of investment?

How long do you need the insurance?

Is this a level of security only until your children are adults? If you're a business owner, is it to hold until a liquidity event? Or is it meant to last throughout your life and be used to pay estate taxes?

How much insurance do you need?

Have you done calculations to determine what you would need as an income replacement? Do you know what your future estate taxes are expected to be? How will your business affect your insurance needs?

The following questions should also be considered, particularly as they concern your tax position:

Who should be insured?

Is it the main breadwinner? both husband and wife? the whole family, including grandchildren? the business owner(s)?

Who owns the insurance?

It's typically not the insured party or the insured party's spouse, or the insured party's business. Most insurance is owned by a special life insurance trust or cross-purchase partnership.

Who should be the beneficiary?

While a spouse or children are typically named as beneficiaries, in many cases the owner of a trust or partnership is named.

Who should pay the premiums?

If a business owner is paying the premiums, there are a number of related income tax issues. And there can be gift tax issues if there is a life insurance trust in place.

The most common use of life insurance is to provide upon the death of the insured an amount of cash for the care of surviving family members. The death proceeds can be set aside either in income-producing investments (substituting for the breadwinner's wages) or to pay off mortgage obligations. Today's family often has more than one breadwinner and may need a life insurance program providing coverage for several breadwinners based on the earnings levels and insurabilities of the family members.

Because the life insurance proceeds must be available at the death of the breadwinner, traditional single-life products (rather than second-to-die products) are more appropriate. The most cost-effective

product is usually level-premium term insurance; however, no simple formulas can determine how much life insurance you need (such as a multiple of salary). Rather, you should consider many factors, including accumulated wealth, liquidity needs, earning power of surviving family members, projected expenses, family involvement and support, and other sources of income, such as pensions and Social Security.

When determining coverage needs, keep group term life insurance in mind. Group term is an employee benefit available to most full-time employees through their jobs. Often, additional, supplementary coverage can be obtained through employer-sponsored arrangements. However, because this coverage is available to all employees without the need for a physical exam, it can sometimes be more expensive than coverage purchased in the marketplace.

Annuities

An annuity is a form of investment sold mainly by insurance companies. Annuities provide for tax-deferred investment returns within the contract. Payments from the annuity can be arranged to continue for life (called a true annuity) or for a set number of years.

Immediate annuities provide payments starting right away. Deferred annuities provide payments beginning at some date in the future. Fixed annuities provide an investment return based on a set interest rate—usually set by the carrier each year. Variable annuities provide an investment return based on investments chosen by the contract owner.

Investment earnings are not subject to income tax until withdrawn from the annuity. All investment earnings are subject to ordinary income tax (no special dividend or capital gain rates are available). Withdrawals made prior to age 59½ attract a 10% excise tax on the investment portion (similar to an individual retirement account). If the owner dies, payments made to beneficiaries continue to be ordinary income.

Because annuities have a life expectancy component, they usually have an additional layer of fees and administrative charges compared with other investments. That additional layer of expenses is a significant disadvantage.

The most modern form of annuity is the variable annuity with secondary guarantees—in the form of guaranteed minimum investment returns. Variable annuities are particularly attractive to those not willing to invest in the stock market for fear of losing money. They offer the potential for good returns from the market while offering an acceptable minimum level of return if the stock market does not do well. They deserve particular attention from conservative investors.

Insuring businesses and their owners

Business owners use life insurance for many reasons, including:

- / To continue operations after the loss of a key employee
- / To provide survivor income for the family
- / To provide liquid assets for estate taxes
- / To provide an equalizing inheritance for other children
- / To fund buy/sell agreements
- / To fund cross-purchase agreements

By carefully structuring the ownership and beneficiary designations of a life insurance policy, you can reduce or eliminate income tax, gift tax, and estate tax consequences.

Key-person life insurance

Key-person insurance is designated to provide funds for continuing a business after the death of a key employee (for example, a financial manager, an operations manager, or an ideas manager). Bank covenants sometimes require this type of insurance. The amount of insurance should be tied to the costs of searching for and hiring a suitable replacement (which could involve additional salary costs), as well as any temporary professional management costs.

Normally, the business owns and is the beneficiary of the key-person insurance policy. If the insured key employee is later replaced by another employee, many carriers will substitute the new employee for the prior employee in the existing policy rather than issue a new policy, although such substitution usually involves income tax consequences.

Income tax and estate tax issues are not the primary concerns with key-person life insurance. Instead, it is driven by business issues.

Survivor income, estate taxes, and inheritances

If the business owner is also the family's sole wage earner, the survivors may have additional problems. Due to technical tax rules, a business sometimes finds it difficult to put funds into the hands of the surviving spouse and children. Therefore, many business owners purchase life insurance to provide a temporary source of funds for the surviving family until the business's future is settled.

On one hand, most businesses, although quite valuable, can be illiquid in the hands of the estate administrator. On the other hand, life insurance is very liquid at the death of the insured. Business owners often purchase life insurance to pay estate taxes, especially when it is desired that the business stay within the family.

Finally, insurance can provide a separate inheritance for children who will not share in ownership of the business. For example, one technique is to leave ownership of the business to the children who will be involved in managing the business and to use life insurance for creating enough liquidity at death to provide for children who will not continue with the family business. This often avoids intrafamily conflict based on passage of ownership of the business to siblings as passive investors.

Insurance funding for buy/sell agreements

Life insurance for business transition must be arranged in a tax-efficient manner.

Changes in the owner or beneficiary can produce radically different tax results. This is especially true with buy/sell agreements.

A common arrangement is for the company to purchase life insurance on shareholders' lives. The company is the owner and beneficiary of the policy, and the company makes all premium payments. The shareholder agreement calls for the company to purchase shares from any deceased shareholder's estate or family members. The technical term for this arrangement is redemption.

Corporate redemption arrangements

A corporate redemption (buy/sell agreement) funded by corporate-owned life insurance is not a tax-efficient way to transfer ownership at death. The major issues are as follows:

- / Distortion of the business value, because the insurance death benefit is added to the value of the business for estate tax purposes
- / Potential corporate-level income tax on the insurance death benefit (alternative minimum tax)
- / Complicated tax rules associated with purchasing stock from the estate, especially when payments take place over time
- / No basis increase in the stock held by the remaining shareholders

Despite all of those tax issues, the redemption buy/sell arrangement is the most common form of dealing with the death of a business owner. It is the easiest arrangement to put in place.

Insurance funding for cross-purchase agreements

A more tax-efficient (and more flexible) arrangement than the traditional buy/sell agreement is the cross-purchase agreement. In this arrangement, the other business owners agree to buy the deceased owner's shares. The company itself is not part of the agreement.

Due to technical tax rules, a business sometimes finds it difficult to put funds into the hands of the surviving spouse and children. Therefore, many business owners purchase life insurance to provide a temporary source of funds for the surviving family until the business's future is settled.

The owners of the business purchase life insurance on each other's lives. Only one policy per owner is needed (multiple policies are not required). The owners create a special partnership to hold the life insurance. The partnership is the owner and beneficiary of the policies and makes all premium payments. At the death of a shareholder, the partnership distributes the cash to the remaining shareholders, and they purchase the deceased owner's shares.

This arrangement has the following advantages:

- / No distortion of the business value, because the insurance death benefit is not added to the value of the business for estate tax purposes
- / No potential corporate-level income tax on the insurance death benefit (alternative minimum tax)
- / No complicated tax rules associated with purchasing stock from the estate
- / Full-basis increase for the stock held by the remaining shareholders

The types of policies used for funding cross-purchase arrangements typically are permanent types of life insurance (since the arrangement is likely to continue for a long period of time), such as whole life, universal life, and variable life.

Nonqualified deferred compensation

Many corporations both large and small use life insurance as the investment mechanism to provide funds for employee perquisites such as deferred compensation plans and supplemental executive retirement plans. Such company-owned life insurance policies involve special income tax, financial accounting, and investment features.

Congress more than once has changed the income tax treatment of life insurance policies owned by corporations (especially the interest expense on policy borrowings). Despite those changes, life insurance funding for deferred compensation remains a viable alternative.

In the typical arrangement, a corporation purchases life insurance policies on the lives of the participants in the executive benefit plan. Policy premiums are paid each year and reduce current earnings but are not deductible for income tax purposes. New tax laws require that companies (1) obtain an executive's permission before purchasing the policy and (2) provide information on the policy for the Internal Revenue Service (IRS) with annual tax filings. Policies on individuals who are not executives or employees at death have less favorable tax consequences.

The cash value in the policies builds during the employment years and represents an asset of the corporation. When benefit payments are scheduled to begin, the employer borrows from the cash value to pay the benefits. The benefit payments produce compensation for the executive and a tax deduction for the corporation. Finally, the death benefit, which is paid to the company, is normally income tax free as long as the insured individual was an executive, a shareholder, or an employee shortly before death.

As a practical matter, such arrangements require careful bookkeeping and can create cash flow issues for the corporation. In addition, it's sometimes difficult to tell whether you have an economically successful arrangement until all of the insured executives are dead. The arrangement is especially problematic if there is turnover in the executive ranks, which necessitates turnover in life policies, thereby defeating the income tax advantages.

Tax implications of life insurance

The income tax treatment of life insurance policies generally is governed by the IRS and a series of court cases and revenue rulings. According to the IRS, a series of actuarial calculations must be performed in order for a policy to qualify for life insurance income tax treatment. Those calculations address the relationship between cash value and death benefits, and the death benefit must be a multiple of cash value based on age. Most life insurance carriers have software

to make these calculations and can advise whether the policy you buy will be treated as life insurance.

If a policy is not treated as life insurance, the income tax treatment of annual earnings, withdrawals, loans, partial surrenders, and even the payment of death benefits will be impacted. None of the special income tax rules associated with life insurance will apply.

Income tax advantages

Life insurance that is not treated as a modified endowment contract (explained later) has a number of income tax advantages:

- / The death benefit normally is not subject to income tax.
- / The cash value buildup is not currently subject to income tax.
- / Removal of funds from the policy via policy loans is not treated as taxable income as long as the policy stays in force.
- / Removal of funds from the policy via withdrawal is treated first as a return of premiums and second as taxable income.
- / Policy dividends are treated first as returns of premiums and then as taxable income after all premiums have been returned.

Interest on policy loans

Unfortunately, a number of limits apply to the interest expense on policy loans. For individually owned policies, interest on policy loans typically is treated as personal interest expense and, therefore, is nondeductible. For corporate-owned policies, the interest expense generally is nondeductible unless the policy was purchased before June 21, 1986, or unless the insured is a key person and borrowings are limited to \$50,000.

Modified endowment contracts: When life insurance is an annuity

Life insurance policies categorized as modified-endowment contracts are life insurance policies with so-called excessive premium payments or deposits in relation to the death benefit. A series

of complex actuarial tests must be met to avoid modified-endowment-contract status, which is advisable, because modified-endowment contracts typically receive unfavorable income tax treatment. Most carriers can test planned premium payment alternatives to avoid modified-endowment status and can make representations to you about whether a particular policy avoids modified-endowment status.

If a policy is classified as a modified-endowment contract, distributions from the policy—whether by withdrawal, partial surrender, or policy loans—are treated as annuities for income tax purposes. This means that the funds removed from the policy will first be treated as ordinary income rather than as a recovery of original cost (which is not taxable). The death benefit remains income tax free.

Lapse or surrender of policy

The lapse or surrender of a life insurance policy is treated as a taxable event. The amount received in cash (including previously borrowed amounts) in excess of premiums paid is treated as ordinary income. This is a particularly severe result if the policy is being used as a private pension, because the borrowed funds may have been previously consumed to support a retirement lifestyle and are not available to defray the income tax costs associated with the policy surrender.

Life insurance and paying estate taxes

Estate taxes can be very heavy financial burdens for a family, particularly if the estate holds closely held stock or other illiquid assets. Using life insurance proceeds to provide liquidity for estate taxes can be an effective planning strategy and can provide the family with cash to pay estate taxes without the necessity of selling assets at fire-sale prices.

Moreover, with the judicious use of life insurance trusts and annual gifts to the trust, you can remove the proceeds of the life insurance from the taxable estate and pass them on to future generations free of estate taxes.

Under current federal estate tax laws as well as most state estate tax regimes, the major estate tax is not due until the death of the surviving spouse. Thus, estate taxes usually are postponed until the survivor's death. To provide cash to pay estate taxes, the policy should insure both the husband and the wife but not pay until the death of the survivor. This type of insurance is known as second-to-die insurance, or survivorship life insurance, and is discussed later.

Although you can determine in a quantitative way the amount of coverage needed (by calculating the growth of your estate and the corresponding estate tax at various points in your career and retirement), many families also consider in the analysis both a target inheritance for their children and grandchildren and a target premium.

If you perform quantitative calculations, make sure they include a variety of sophisticated gift giving strategies to control the growth of the estate—and reduce the need for insurance. These strategies would include grantor-retained annuity trusts and sales to grantor trusts. (For a more detailed discussion of gift giving strategies, see chapter 4, “Estate and gift planning,” page 34.)

A very popular form of survivorship insurance is a universal product with guarantees. With this form of universal life insurance, the coverage is guaranteed regardless of changes to interest rates, as long as you make premium payments on time. The cost of coverage can be compared easily from carrier to carrier. Unfortunately, some carriers are injecting additional variables into the pricing by changing the coverage guarantee.

For a more detailed discussion of life insurance considerations, please visit pwc.com/pfs.

Special considerations

When working with an insurance agent, be aware of the agent's role: the agent may be making a commission based on the insurance products sold to you. This may impact the information you are presented

with in your pursuit of risk management as part of your overall wealth plan. (For more on this topic, see chapter 10, “Working with financial advisers,” page 86.)

Life insurance as an investment

Sometimes life insurance is purchased not for its death benefit but to obtain favorable tax consequences for the investment of the policy's underlying cash values. In these cases, the policy is being used essentially as an investment wrapper. Life insurance is attractive as an investment product because insurance policies have special income tax rules that apply to withdrawals and death benefits. However, those same special tax rules can also drive up policy administration expenses, which erode investment results. In addition, surrender charges and fees make any life insurance investment a very long-term commitment.

For information on how life insurance can be applied as an investment or in a charitable trust, please visit pwc.com/pfs.

Trends in life insurance policy choice

Temporary life insurance needs are most often met via level-premium term insurance. You pay the same amount for a set number of years (5 to 20 depending on age), and then the coverage ends. This is very cost-competitive insurance without any additional features (adding features to life insurance makes comparing policies nearly impossible).

Longer-term life insurance needs used to be met with whole life insurance. This type of coverage is very predictable but inflexible. Universal life insurance became popular in the 1980s and 1990s (a period of relatively high interest rates) because purchasers could vary premiums, and agents could engineer policy returns to illustrate lower premiums. But many of the interest rate assumptions built into the illustrations could not be sustained.

Variable life insurance—wherein the policy owner could choose the investments, much like a 401(k) plan—became popular in the late 1990s. Again, policy illustrations could be provided based on robust stock market returns and reduced premiums; and

many universal life and whole life policies got surrendered in exchange for variable life coverage. With the major market declines in 2001–03 and again in 2008, the variable policy has lost its popularity.

The latest form of coverage is universal life with so-called guaranteed coverage. As long as certain minimum premiums are paid each year, the coverage is guaranteed to continue for life no matter what happens in the markets. This guaranteed coverage is currently most popular for those seeking long-term life insurance coverage (for estate tax payments and business transitions).

Second-to-die, or survivorship, insurance
Second-to-die insurance (also known as survivorship insurance or joint life insurance) pays a benefit upon the death of the second of two insured lives. These policies are very useful in estate planning because their benefits can be used to pay estate taxes triggered by the death of a surviving spouse. The feature is further enhanced if the policy is owned by an irrevocable life insurance trust.

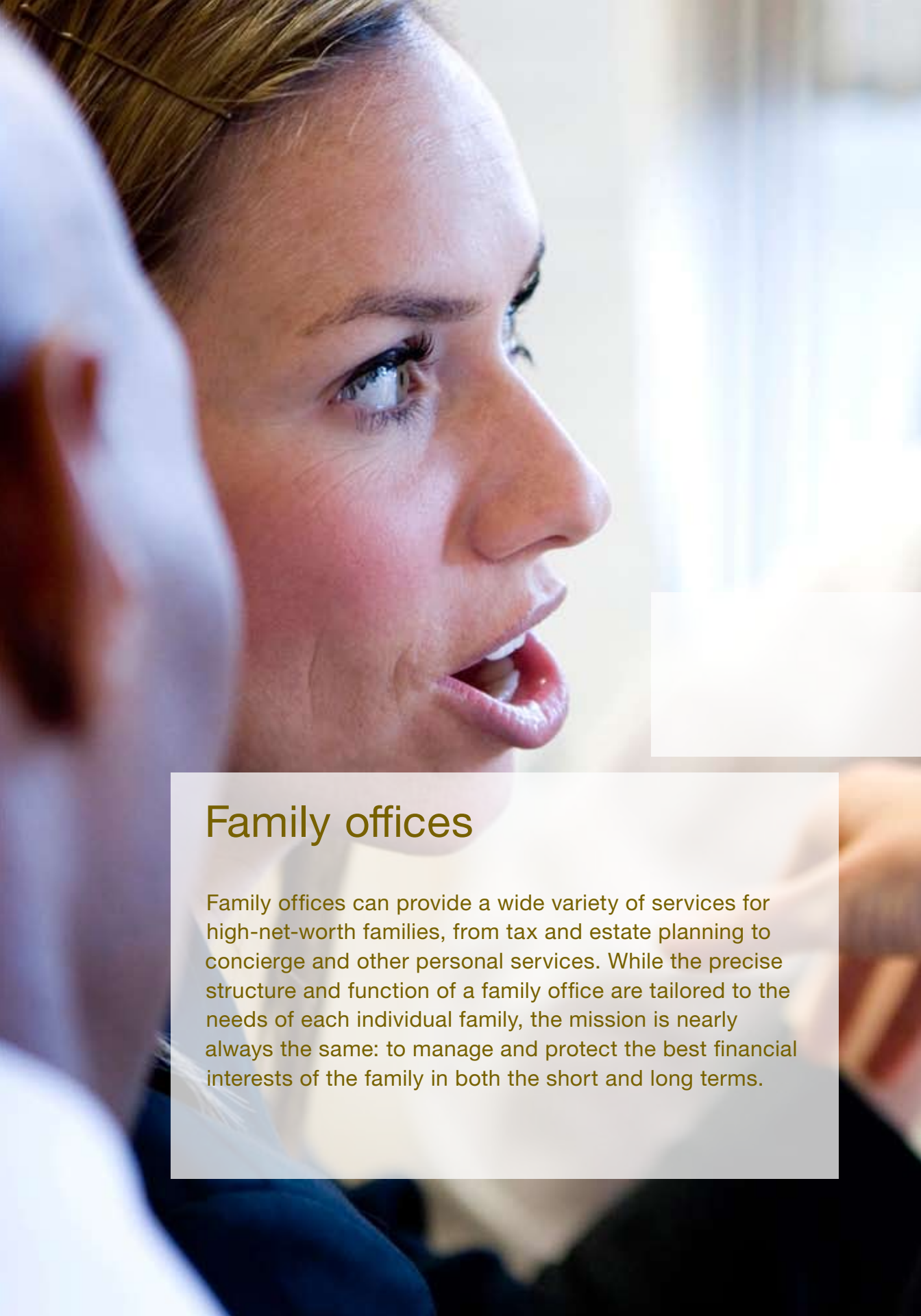
For additional information on irrevocable life insurance trusts, please visit www.pwc.com/pfs.

Diversification

Life insurance is an insurance carrier's promise to pay. That promise is only as strong as the carrier. As with any investment, diversification among life insurance carriers is important. Large amounts of death benefits should be placed with a variety of carriers, since the best or safest carrier today may not be the best or safest carrier 20 or 30 years from now. Several independent agencies such as Fitch Ratings and Moody's Investors Service provide ratings for insurance companies, and those ratings can be helpful in selecting insurance carriers with financial strength and stability.

Conclusion

Insurance preserves and protects the assets you value most: your health and your wealth. This makes insurance a critical component of a sound financial plan.



Family offices

Family offices can provide a wide variety of services for high-net-worth families, from tax and estate planning to concierge and other personal services. While the precise structure and function of a family office are tailored to the needs of each individual family, the mission is nearly always the same: to manage and protect the best financial interests of the family in both the short and long terms.



The family office began in the United States during the Industrial Revolution, when businesspeople such as Rockefeller, Carnegie, and Du Pont needed help managing the amount of wealth they had amassed. The family office became a way to help manage that wealth and to maintain it for generations to come. In the past decade, family offices returned to the forefront after the Internet boom created a new set of wealthy families in need of structure and guidance to manage their wealth and assets.

The family office is staffed with a combination of in-house and outsourced professionals, who help manage the family's assets and lifestyle. Usually, the family office is formed to provide current oversight for the family's assets and to make sure that the family's legacy is

managed and maintained. It oversees such functions as asset management and investments, real estate management, education, philanthropic activity, tax return preparation, accounting, bookkeeping, and lifestyle management. In addition, family offices provide key financial advice and services, and most maintain a staff skilled in wealth and investment management. However, the family office does not usually manage the family assets directly or select the individual stocks and bonds in a family's portfolio.

The mission of the family office is to manage the best financial interests of the family, which can be enormously valuable in the face of economic turmoil and can allow family members the time to focus on other priorities.

Benefits

Family offices can provide a plethora of complex services often required by high-net-worth families and individuals. Such services include:

- / Bookkeeping and accounting
- / Tax planning, preparation, and compliance
- / Trustee services
- / Estate planning
- / Risk management
- / Family governance
- / Philanthropy and administration
- / Life management
- / Gatekeeping (controlling which individuals and entities have access to the family or to family information)
- / Concierge (personal) services

One of the cornerstones of a family office is objective financial advice. Many families already employ outside financial professionals, such as accountants and investment managers. The family office, responsible for overall management of the family, can quarterback those advisers. And it sets the overall investment strategy by determining what proportion of the total portfolio will be allocated among equities, real estate,

and other various investment vehicles. It also plays a role in determining the level of investment risk befitting the family. Additionally, a family office selects individual money managers, performs extensive due diligence, and subsequently evaluates the performance of the portfolio for the family.

The family office builds a broadly diversified portfolio for the family—including but not limited to foreign investments, equities, debt instruments, private equity, hedge funds, and commodities—and consolidates these with other assets into one financial plan. Many high-net-worth individuals and families commonly split their investment portfolios among a number of different investment managers. In some cases, each investment manager might be operating under the assumption that it has been entrusted with a substantial portion of the portfolio—if not the entire portfolio—while in actuality, that investment manager has only a small portion. This may and often does lead to investment managers' handling and allocating assets differently than they might do if they knew that they were in control of only a portion of the client's portfolio. This can be avoided when the family office coordinates the individual investment managers; the office ensures each manager understands its role in the larger investment strategy and makes investment decisions accordingly.

Because of the complicated nature of the portfolios involved, the family office is often required to deal with a significant number of different investment managers and analysts, who may come with their own ideas and recommendations. In this way, the office can act as a gatekeeper by consolidating the ideas of managers and analysts and offering the family a single touch point.

With a complete picture of the family's total investments as a single unit, the family office, using its own financial planners, can work to make the best decisions and investments based on a high-level view. For example, a family

office could assess each of the investments already held by the family, determining where they fit in a specific financial plan. Family offices can provide families with all of their investments and portfolio activities consolidated and summarized onto one single report, which increases the transparency of the information and of the investment process. If some investments seem to be too heavy in a particular asset class or if certain investments are not effectively fulfilling their roles in the portfolio, the family office can identify those areas and recommend appropriate measures—whether they be specific retentions, dispositions, or additions—to take to improve the overall plan and the performance of the investment portfolio.

Creation and operation

Typically, a family with a net worth of more than \$50 million may want to consider establishing a family office. In such a case, the family office would enable family members to focus their time and attention on other pursuits—such as running the family business, philanthropy, and outside careers—aside from managing the family’s financial wealth.

A family office is usually defined by how many families it serves: either a single-family office (SFO) or a multifamily office (MFO). Beyond this initial distinction, there is no standard structure for a family office; each is designed by a family to fit that family’s unique sets of needs and objectives.

Single-family office

The SFO can offer a variety of services, from real estate management and estate planning to philanthropy and education. The business model of an SFO can be tailored to the specific goals and objectives of the family. Most SFOs are made up of entrepreneurial families, many of which own their own businesses and/or possess a majority of the seats on their businesses’ boards of directors. Most of these families see the family office as more of an investment vehicle, where the office is usually run by a family member, such as a retired member of the

family business. Its main purpose is investment, and the other activities for that single family—such as concierge service, education, philanthropy, and other, less important tasks—are outsourced to other companies.


While an SFO enables a family to maintain privacy and independence, it can be expensive, as the cost of recruiting and retaining top talent continues to increase. However, families can apply benchmarks to create a family office that delivers a measurable and reasonable return on investment. Families define returns on investment differently. Considerations include the time freed up for the family, tax savings achieved through increased tax planning, greater investment rates of return compared with industry benchmarks, and continued management of the estate to reduce estate tax liability. In other words, the family office should be considered a way for the family to leverage decisions, actions, and opportunities by those who are more qualified and focused.

Multiple family office

To spread the costs of recruiting and retaining top talent across a larger base of assets and income, many families turn to the MFO.

MFOs operate similarly to SFOs, but they are tasked with managing more than one family’s interests. Because MFOs are much larger than SFOs, they are often more efficient, and they benefit from established relationships with third-party vendors. MFOs also offer (1) good balance between in-house and outsourced services, (2) transparent prices, (3) world-class investment and service selection, (4) top talent, and (5) no conflicts of interest.

However, because each MFO caters to more than one family, it’s important to be sure the MFO is not spread too thin and is still able to provide the highest-quality service while maintaining confidentiality.

A man with short, graying hair, wearing a dark suit, white shirt, and light pink tie, is looking off to the side with a thoughtful expression. He is holding a stack of papers in his hands. The background is blurred, showing what appears to be a modern building with large windows.

Example: *Mark has four different investment advisers, two tax advisers, two attorneys, and an executive assistant who helps with personal matters. Mark travels a lot, and he's having difficulty both keeping track of the cash draws he must pay into the partnerships in which he's invested and making sure his business and personal bills are paid on time. He always has cash in his bank account but doesn't know where it's going. At the same time, he's trying to develop a wealth management plan for his family, and all of his advisers—investment, tax, and legal—are giving him different, and sometimes conflicting, advice. It's confusing and time-consuming, and he wants to simplify things by establishing a single point of contact.*

Mark decides to establish a family office to manage all of the service providers. The family office manages the cash flow of the family, pays bills, and provides financial statements that consolidate the financial statements of all of the investment advisers. And the family office evaluates, hires, and manages all of the investment advisers, watches interest rates, and refinances debt when advantageous. As compensation for those provided services, the family office manager receives a percentage of the increase in the value of Mark's family's portfolio.

Tax implications

A family office may benefit a family in other ways. For instance, having a number of individuals within a family represented as a single unit can lead to various advantageous tax-planning strategies and tax efficiencies.

Working closely with the investment adviser, the family office can ensure that the investments chosen are tax efficient so as to reduce the tax consequences to the family. In addition, depending on the family's business there may be opportunities to set up tax-deferred retirement plans.

The family office can also assess the tax implications of wealth transfer and estate planning. Because the family office focuses on multigenerational wealth transfers, it can evaluate possible strategies, including yearly gifting plans and the creation of various trusts.

Finally, if the family office is structured properly, some of the associated costs may be deducted above the line, as opposed to a miscellaneous itemized deduction. The advantage here is that due to the 2% floor, high-net-worth taxpayers often receive no tax benefit for a miscellaneous itemized deduction. Above-the-line deductions do not have that same limitation and therefore create a tax savings.

Special considerations

The focus of the family office is often on the long term and, in turn, the creation of transgenerational wealth. The family office attempts to manage current and future family assets in a manner that will ensure that there will be sufficient assets available to subsequent generations. The office coordinates the different financial plans of individual family members while also preparing a financial plan for the entire family, including members of present and future generations.

That focus plays itself out in a variety of ways. Perhaps the most obvious result is that family assets get placed into long-horizon investments that may not achieve as high initial returns as do other outlays but that have much greater potentials in

the long run. In financial planning, the family office might also consider the financial plans of parents and grandparents when preparing financial plans for children and grandchildren, who will likely inherit much of the older generation's assets. This focus lends itself to helping subsequent generations gain an understanding of the family wealth and to getting subsequent generations involved in the family company management.


One major distinction between a financial plan created by a family office and one created by other investment advisers is that the family office deals with a much broader range of assets, including traditional, investment assets and noninvestment assets. Such noninvestment assets include private airplanes, artwork, yachts, and other valuable property. The family office's investment advisers recognize the important role that such nontraditional assets play in the wealth of a family, especially when those assets will be passed down for several generations. Family offices are more knowledgeable and better equipped to handle and deal with these types of assets and therefore contribute an added benefit.

Family offices are becoming very popular. As a result, more resources are available to them to help them in the management and benchmarking of the office. Those resources include family office networks, family office conferences, and various other family office organizations and communities. These communities can provide additional guidance for the family office as well as provide objective knowledge, information, and advice to more effectively manage their office.

Conclusion

The precise structure and function of family offices are customized according to the needs of each individual family. While every family is different, the mission of a family office is nearly always the same: to manage the financial interests of a family while working toward short- and long-term goals.





Working with financial advisers

Much like running a business, personal wealth management is best approached with the counsel of trusted advisers. Working with a team of financial advisers assembled to suit your specific needs enables you to take a controlled and strategic approach to your own unique wealth management goals.

Managing personal wealth is, in many ways, like running a business. Successful business leaders develop strategic plans for growth in consultation with a group of advisers such as a board of directors, and individuals should manage their financial matters—including investments, taxes, charitable giving, and so on—in the same way. Working with either a financial adviser or a team of advisers lets individuals take a more controlled and strategic approach to all aspects of wealth management—from meeting growth goals and reducing risk to managing taxes and planning for future generations.

Creation and operation

Develop your financial goals

The first step in creating a relationship with a financial adviser is to understand your own personal financial goals. In the short term, do you want to better manage your taxes? improve your investment strategy? contribute to financial security in retirement? Also think about long-term goals for yourself and your family: how do you plan to transfer your wealth, both during and after your life? Even if you have only a general idea, discussions with your adviser can help you arrive at a clearer, more detailed understanding of what you want your financial plan to achieve.

Research your options

Once you know your general financial goals, you can do some research to find an adviser whose skills will support those goals. Personal recommendations from people you trust are helpful as a starting point, but the decision requires careful and dedicated consideration. You should analyze a potential adviser as you would any major business decision.

- / Review the adviser's resume, qualifications, background, years of experience, and referrals.
- / Request the tax and income profiles of the adviser's other clients. Reviewing those profiles will indicate whether your circumstances fall into a profile the adviser is accustomed to addressing.
- / Determine what services the adviser provides.

- / Find out how the adviser approaches financial planning so you can get an idea about the process used.
- / Ask how the adviser is paid for services.

You should also determine whether you want to hire a financial adviser to serve as part of a team or to serve two roles: filling one spot on the team as a tax specialist and also serving as the team's point person.

Structure your team

To successfully create and monitor a financial management plan, you need a team working on your behalf. The team should include yourself, your spouse and your spouse's advisers, a tax adviser, a lawyer (perhaps multiple lawyers depending on real estate needs, estate/gift tax needs, etc.), an insurance adviser, an investment adviser, and, if applicable, a trustee. As indicated earlier, you want one team member to serve as point person. Another way to think of this is that the point person is your "board" CEO, and you are the chairperson. The point person's job is to help articulate your strategy, develop the plan, and direct the utilization of the other team members toward achieving your goals. This financial adviser will, ideally, fill one specific role on your team—often, people find that the tax adviser in that role is effective because taxes tend to touch everything in your plan—but also offers enough expertise in the other areas of your plan to effectively manage the team for your purposes. This approach lets you focus on the vision and priorities for managing your wealth and enables the experts to ensure effective implementation.

Developing a true and trusted adviser relationship with someone who is able to place your needs in the contexts of all of the different tax/strategy/investment/risk management products and instructions is the best way to achieve overall wealth management success. To this point, it is important to use your street smarts when considering a financial adviser. Is this a person you can trust? Does the perspective the financial adviser is offering in creating your road map feel right to you?

Build trust with your adviser/adviser team
Advisers should earn your trust. They should neither be given it nor expect it. Your trust should not be given up front based simply on a recommendation. As you start working with your adviser/adviser team, provide them with your goals and ideas and then see what results they deliver: this should be your measurement for building trust. Prioritize your needs and have the adviser/adviser team start by addressing the goals one at a time (consider starting with something lower on your list), thereby giving you the chance to assess how the adviser/adviser team works with you.

It is useful to set expectations early on: How often do you want to communicate with your adviser? What kind of reporting do you expect? Financial planning is very personal; there is no cookie-cutter approach, so you should not hesitate to build a unique framework that makes you feel comfortable and in control.

Attend to timing and adjustments
Once you've established a trusted adviser relationship, you should meet with your adviser or team at least quarterly. Over time, you'll become better able to assess the frequency of ongoing meetings and/or discussions based on how your plan is progressing and on how things may change. The meetings should follow an agenda: start by addressing old business, and then move on to new business based on what's happening in the marketplace, throughout the legislative landscape, and within your family or family business. Significant changes that impact your financial situation, goals, and overall financial well-being should be discussed with your adviser/adviser team in a timely manner.

Exercise patience
People tend to be quick to hire an adviser because they want to get it over with, but this is ill-advised. Again, the process should be approached with the same dedication and due diligence you would bring to a major business decision. Exercising patience in building your financial adviser team can bring tremendous long-term benefits: Think of it as

selecting a board of directors. This group will drive your financial plan, growing and maintaining your wealth throughout your life and into future generations. You want to build as competent a team as possible.

Tax implications

The tax law provides that a deduction is allowed on an individual income tax return for expenses paid or incurred that are ordinary and necessary expenses “for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax.” Examples of some common deductible financial adviser expenses are:

- / Fees for investment advice and management, including service charges on dividend reinvestment plans
- / Custodial fees for individual retirement accounts (IRAs), Savings Incentive Match Plans for Employees of Small Employers (SIMPLEs), simplified employee pension plans (SEPs), and self-employed qualified plans if paid with funds from outside the plan
- / Fees for tax preparation, planning, and advice
- / Fees for estate planning (related to tax matters only)

Because a financial adviser may provide both deductible and nondeductible services, it's important to request from your adviser an itemized bill that gives a detailed explanation of the services performed.

Common concerns about working with an outside adviser

Usually, people hesitate to work with financial advisers because of a lack of knowledge: they're unsure of exactly what services financial advisers provide, how to evaluate potential advisers, and how much they should expect to pay for the service. Personal finances, though, are just that—personal—and without sufficient information, it can be very difficult to trust an outsider with such an important aspect of one's life. So it's critical to understand not only what a

financial adviser does but also how to manage that relationship to best position yourself for future personal financial success.

What is a financial adviser?

What do financial advisers do? Are they tax planners? product sellers? investment strategists? The very definition of a financial adviser covers a wide range of skills and services, leading to confusion about what is expected in the role.

Ideally, a financial adviser is someone who specializes in one financial area (like taxes, financial products, or investment strategies), assists you in that area, and, based on the adviser's (or the adviser's firm's) resources, leverages additional resources to provide help in the other areas important to your financial well-being. Think of an adviser as the one getting you from point A to point Z by taking into consideration your goals, income, and financial assets and then crafting the road map that will keep you focused on achievement. A financial adviser bases that map on personal knowledge, on experience, and on ability to work effectively with other professionals who can contribute to your reaching your goals.

"I don't need a financial adviser; I can handle this myself."

A wide range of issues and considerations go into a sound financial plan, and financial advisers acquire specific certifications and qualifications to provide the specialized services that address those issues. For example, certified public accountants and Personal Financial Specialists have completed extensive study, passed examinations, and met levels of related professional experience in order to provide their services. That training enables these professionals to recognize certain benefits and risks associated with wealth management. A qualified financial adviser will also have the resources at hand to keep abreast of changes and developments in the laws

governing the financial-planning areas that cover taxes, estate and gift taxes, investments, charitable giving, and so forth. All of this makes these professionals far more qualified and capable of handling the complex task of financial planning.

"It costs too much to have a financial adviser."

A financial adviser typically utilizes one of several common payment structures:

- / Hourly rate
- / Flat fee
- / Fee based on a percentage of your overall account value
- / Commissions from products you buy from them, such as investment or insurance products
- / Combination of fees and commissions, which can be framed around certain projects/aspects of your plan or can cover a period of time, such as a retainer fee for ongoing services

Other considerations in the costs associated with a financial adviser are the benefits—such as an effective plan, sound advice, tax savings, and a more effective investment portfolio—attendant upon the successful application of the adviser's services to your wealth plan. In addition, as discussed earlier, there are several tax deductions available that reduce the related costs of working with a financial adviser.

"My business partner has a plan that works well. I'm just going to do that."

Money is an intensely personal issue, and each person's approach to and expectations of it are shaped by the person's unique personal beliefs, upbringing, cultural background, professional experience, and so on. Accordingly, there is a unique wealth management plan for every individual based on personal goals, income, investments, charitable involvement, business needs, age, savings—the list goes on. Only by taking into account these elements can an adviser develop a plan to best fit your individual needs. Simply copying someone else's financial plan is not going to create a long-term financial solution that is ideal for you alone.

“My family does not need to be involved in my work with a financial adviser.”

Most likely, your ideas about wealth management include members of your family in some capacity, whether it involves, say, wealth transfer, succession planning for the family business, or planned charitable donations. Including family members in the wealth management process is important for a number of reasons.

- / If you and your adviser do not know what the long-term goals of your individual family members are, you will not develop a plan structured to reach those goals.
- / The best way to ensure that your spouse and children will make savvy financial decisions is to provide them with hands-on financial education and to involve them in meetings—and decision making—with your financial adviser.
- / In the event of your illness or death, you want your family members to be aware of the current financial plan and to be acquainted with your adviser so they can continue the relationship.
- / The best legacy you might leave your family members is one that empowers them with the knowledge and skills to continue not only your family value system but also your family wealth management system.

Special considerations

Once you’ve undertaken the effort to create a relationship with a financial adviser/adviser team, there are additional steps you can take to make the relationship successful.

- / **Keep the control.** Through your communications and interactions with your adviser, make sure your goals are being met. If you’re unsatisfied with your adviser or a member of your adviser team, address the issue. Ask questions, and don’t shy away from challenging an idea if it doesn’t seem to support your overall goals.

- / Continue to play a lead role in setting agendas for adviser meetings, and clarify expectations as needed. Hold your lead adviser responsible for keeping your adviser team both objective and focused.
- / Consider setting performance goals for your adviser/adviser team. This type of reporting back to you as a client will help track (1) the relationship between you and the adviser/adviser team and (2) the progress of your financial strategy.

Conclusion

“If you don’t know where you are going, any road will take you there.” Lewis Carroll’s saying is very pertinent to working with a financial adviser and establishing your wealth management plan. Choosing an adviser is an important decision that will affect your long-term financial well-being. And financial planning is a personal process that is unique to each family and individual; clarifying your own goals and selecting the right adviser or team of advisers to help you achieve them will enable you to reach your chosen destination.

In some cases, establishing a family office (see chapter 9, “Family offices,” page 80). may be the best approach. But in all cases, remember that wealth management is a fluid process. It is important to revisit aspects of your plan with your adviser on an ongoing basis and to take the steps that will enable you to maintain a trusting relationship that is flexible, timely, and in keeping with your personal wealth management vision.

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We hope that you find the *2010 Guide to tax and wealth management* to be a valuable tool to guide you in your personal financial planning endeavors.

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