

# *Managing your wealth*

*Guide to tax and  
wealth management*

2014





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***Managing your wealth***  
Guide to tax and wealth  
management



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### ***October 2013***

Wealth management and tax planning, done right, require care and a thoughtful approach. This has been particularly true these past several years, as high-net-worth individuals and their families looked to recoup losses from the early days of the financial crisis — and then determine the best path forward in the long term.

Five years have elapsed since the financial crisis was at its acutest. Here in the United States, various impacted industries are reviving, stock-market volatility has decreased, and the US economy continues to see slow but steady growth. High-net-worth families have good reason to be optimistic.

Few of them, however, have forgotten the lesson learned five years ago — namely, that none of them can afford to let their wealth management run on autopilot anymore. It is no longer enough to choose the right strategy and advisors. Rather, high-net-worth individuals need to be actively engaged in the decisions made on their behalf.

Active engagement requires asking advisors the right questions and reviewing their answers regularly. To ask the right questions, individuals must have a sound understanding of wealth management principles and how to apply them in a variety of contexts, ranging from personal tax planning to the transfer of a business. Equally important is the need to communicate this understanding across generations so that the ability to protect the family's wealth and steward it into the future is a family enterprise, not a responsibility entrusted to just one person.

These days, high-net-worth families also recognize the need to be alert to political and economic dynamics at home and around the globe. US lawmakers continue contemplating tax-law changes that could have considerable implications for wealth management plans for years to come. In the meantime, individuals will have to be mindful of the changes that took effect at the beginning of 2013, including two new taxes that are meant to help fund the Affordable Care Act. These changes make it important for you and your advisors to look anew at your wealth management plan this year.

*Ideally, protecting the family's wealth and stewarding it into the future is a family enterprise, not a responsibility entrusted to just one person.*

Tax and regulatory changes in various other countries may also affect a family's wealth management strategy. Economic and political volatility in the Eurozone and other regions, coupled with the complexity of navigating the laws and rules of multiple foreign jurisdictions, require careful attention on the part of international families and globally diversified investors.

Helping you be vigilant in these and all other aspects of your wealth management is the purpose of this guide. Here we will walk you through the key concepts and approaches pertaining to tax planning, investing, charitable giving, estate and gift planning, business succession, family meetings, family offices, risk management, and cross-border considerations. I encourage you to use this guidance to initiate and steer discussions with your advisors and other family members. This should help foster a genuine dialogue, which is critical to enabling well-informed decisions about your wealth management.

Each chapter in the current edition of this guide has been updated for the latest legal, economic, and legislative developments. This year, we have also added a new chapter on cross-border considerations, reflecting the international diversity of high-net-worth families and the global interconnectedness of economies and markets generally.

I hope that you will find this latest edition of our guide helpful year-round. Many of our readers may consult these pages most heavily during tax planning season. I encourage them to also periodically revisit our publication in subsequent months. Issues such as business succession and family meetings — to which we devote individual chapters — merit attention throughout the year. Staying engaged in these and other fundamental areas of your wealth management should help you be well positioned to create value for yourself and your family, now and far into the future.

Sincerely,

A handwritten signature in dark ink, appearing to read "Brian J. Sals". The signature is fluid and cursive, with a large, stylized "S" at the end.

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# *Effective tax planning*





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**Ch1** Staying actively engaged in your personal tax planning is important in an uncertain tax environment.

On January 1, 2013, various changes in the tax code took effect, so you'll want to approach your tax planning with considerable care this year. The changes include those that are meant to help pay for the Affordable Care Act (ACA) and those enacted in late 2012 to address the fiscal cliff. There are also ongoing discussions about making future changes to the tax law to address other policy concerns. High-net-worth individuals should therefore continue to keep an eye on policy developments, bearing them in mind as they discuss tax planning options with their advisors.

### ***Key considerations this tax season***

When income tax rates hold steady, the standard approach is to accelerate deductions into the current tax year and defer income into the next year. As 2012 drew to a close, however, rates were scheduled to rise. Consequently, you and your tax advisor may have decided to take advantage of the lower rates before their scheduled expiration by accelerating income and deferring deductions in your 2012 tax return. Now that no further tax increases loom large, a return to the standard approach of accelerating deductions and deferring income may be appropriate for you. This presumes that your income remains relatively stable from year to year.

In 2013, the top marginal tax rate is 39.6 percent. Married couples who file jointly and have combined taxable income above \$450,000 will enter the 39.6% tax bracket, as will unmarried individuals with income above \$400,000.

The 39.6% rate reflects the expiration of the 2001 and 2003 tax cuts, in addition to tax law changes resulting from the fiscal cliff legislation and the ACA. The latter introduced a 3.8% Medicare contribution tax on certain net investment income. (This tax — called the net investment income tax — is discussed in greater detail later in this chapter.) For people in the highest tax bracket, the overall tax rate associated with interest, dividends, short-term capital gains, and passive income has risen to 43.4% in 2013, reflecting the combined effect of the 3.8% tax and the expiration of the current tax cuts. For qualified dividends, expiration of the tax cuts and enactment of the fiscal cliff legislation has caused the tax rate to rise from 15% to 20%, on top of which there will be the 3.8% net investment income tax for most high-income taxpayers. Bearing these changes in mind as you consider your tax strategy will help you and your tax advisor devise a plan that generates the largest tax savings — both for this year and in the future.

It is important that you stay actively involved in your tax planning. Doing so will help you ensure that the strategy your tax advisor pursues on your behalf adequately reflects and does not compromise your overall, long-term wealth

management goals. To this end, the next several pages describe various tax planning techniques that you may want to consider, based on income type. A separate discussion on tax deductions follows, as does a review of special considerations that may be useful for you to factor into your tax planning conversations this season.

### *Income categories*

The type of income you receive will determine the rate of tax you pay. For tax planning purposes, gross income can be divided into two broad categories:

- Ordinary income
- Portfolio income

Both categories have their own set of considerations that taxpayers should keep in mind.

### *Ordinary income*

Ordinary income may come from various sources, including wages, self-employment income, bonuses, retirement plan distributions, short-term capital gains, interest income, rents, royalties, and trade or business income from partnerships. The next several pages discuss tax planning strategies aimed at preserving the wealth derived from some of these income sources (the role that tax deductions in particular can play in your tax planning strategy is discussed in a separate section of this chapter).

## Top tax rates for personal income

The following table depicts how tax rates for high-income taxpayers have increased since 2012.

	Wages	Long-term capital gains	Qualified dividends	Passive income	Active income from general partnership	Active income from S corp
<b>2012 highest tax bracket</b>	35%	15%	15%	35%	35%	35%
<b>Medicare tax on earned income</b>	1.45%	0%	0%	0%	2.9%	0%
<b>2012 highest marginal tax rate</b>	36.45%	15%	15%	35%	37.9%	35%
<b>Expiration of tax cuts in 2013</b>	4.6%	5%	5%	4.6%	4.6%	4.6%
<b>2013 highest marginal income tax rate</b>	41.05%	20%	20%	39.6%	42.5%	39.6%
<b>Net investment income tax effective in 2013</b>	0.9%	3.8%	3.8%	3.8%	0.9%	0%
<b>2013 top total tax rate</b>	41.95%	23.8%	23.8%	43.4%	43.4%	39.6%
<b>Increase from 2012 to 2013</b>	5.5%	8.8%	8.8%	8.4%	5.5%	4.6%

## *Wages are considered earned income and are therefore subject to the new, additional 0.9% Medicare surtax if certain thresholds are met.*

### **Tax planning strategies**

To implement a tax planning strategy effectively, it is important to understand when your income is earned and when your expenses are deductible. Since individuals are cash-basis taxpayers, income is earned in the year it is actually or constructively received, and expenses are deductible in the year payments are made.

If you are planning to accelerate a large amount of deductions into an earlier year to reduce your tax bill, you should consider how those deductions might impact your tax position the following year. For instance, your deductions might cause you to fall under the alternative minimum tax, which would result in your forfeiting the tax benefit that the deductions would have otherwise given you. Also, determine whether paying expenses early to take deductions could offset income that is taxed at a lower rate. If it were to offset such income, that would result in your paying more overall tax over a two-year period. That's because your income would be higher in the subsequent year and push you into a higher marginal bracket. Keep in mind, as well, that payment of expenses early to claim tax deductions might have cash flow consequences. You and your advisor should consider the cash impact of any tax planning strategy.

### **Wage earners' income**

Generally speaking, deferring or shifting income may be challenging for an individual wage earner. Such individuals might nonetheless want to consider deferring the exercise of options or deferring some income as part of a nonqualified deferred compensation plan, if either opportunity arises. Keep in mind that wages are considered earned income and are therefore subject to the new, additional 0.9% Medicare surtax if certain thresholds are met. This surtax, which took effect in January 2013, is in addition to the Medicare tax that is already being applied to earned income. (The Medicare surtax is discussed in greater detail later in this chapter.)

#### **- Deferring taxable income via 401(k) plans**

Consider making the maximum contribution to your 401(k) retirement plan, since 401(k) contributions lower your current-year taxable income, and the earnings in the plan grow tax deferred. Such contributions will allow you to defer taxable income until retirement years while saving for your future — a strategy worth pursuing regardless of tax rates.

Indeed, we recommend saving for retirement as early as possible, given the impact of compounding interest and the tax-deferred income accumulation. Make sure you contribute enough to your 401(k) plan to receive your employer's match, if the company provides one. Missing out on the company's match program is tantamount to passing up "free money." For many people, a 401(k) match plan is the only way to receive employer funding for retirement.

## *It is possible to use ordinary losses from business activities to offset income from other sources and thus reduce your overall tax burden — but only if complex passive-activity-loss rules don't apply.*

### *Business owners' and self-employed individuals' income*

Business owners or self-employed individuals have more flexibility in the timing of their compensation, as well as in when they pay their business expenses. Because income for cash-basis taxpayers is not taxed until it is received, self-employed individuals have an incentive to defer billing and collections until January 2014. Conversely, individuals may be inclined to accelerate expense payments into 2013, since doing so will enable expenses to offset 2013 income, thus resulting in current tax savings for the individual business owner. Keep in mind that self-employment income is subject to the new 0.9% Medicare surtax tax if certain thresholds are met.

- **Using business losses to offset your tax liability**  
Taxpayers who are decision makers for their businesses may have influence over the timing of income and of expense payments. It is possible to use ordinary losses from business activities to offset income from other sources and thus reduce your overall tax burden — but only if complex passive-activity-loss rules don't apply. These rules provide that losses will be allowed in the current year only if the taxpayer is actively involved in the business. When using this tax strategy, taxpayers should also consider its impact on their self-employment tax position.
- **Bonus depreciation: Additional tax deduction for business owners and landlords**  
Special or “bonus” depreciation allows taxpayers to claim an additional deduction for certain tangible business property in the year the property was placed in service. Taxpayers can deduct 50% of the cost of certain items placed in service during 2013.

In 2014, bonus depreciation will no longer be allowed, unless Congress acts to extend this provision. To take advantage of the deduction while it's still available, individuals who are considering making capital improvements to business assets might consider accelerating into 2013 the date that such assets are placed in service. Bonus depreciation is not phased out for high-income taxpayers or for those with large amounts of qualifying property. Generally the property must be new to qualify for bonus depreciation.

- **Offsetting ordinary income via SEP-IRAs and solo 401(k) plans**

Self-employed individuals can also take advantage of contributions to retirement plans. An individual with a simplified employee pension individual retirement account (SEP-IRA) may be eligible to make a contribution up to the lower of \$51,000 or 20% of net self-employment income after deducting self-employment tax. Making such a contribution will offset the ordinary income earned in 2013, which will, in turn, reduce the individual's overall tax burden.

A SEP-IRA plan is relatively easy to set up with any financial institution; the deadline for setting up and funding a plan is as late as the due date of your 2013 individual tax return, including extensions (October 15, 2014 if your return is extended). This gives you significant flexibility in how you time your contribution, as well as allows you to determine the exact maximum contribution that can be made.

Alternatively, a self-employed individual can establish a solo 401(k) plan. Advantages that a 401(k) has over a SEP-IRA include the ability for the individual to take a loan from the plan, which is not allowed with IRA-type arrangements. The maximum total contribution that an individual is allowed to make to a solo 401(k) is the same that is allowed for a SEP-IRA (\$51,000); however, the percentage of income limitation on SEP-IRAs and solo 401(k) plans is calculated differently. Therefore, individuals earning less than \$200,000 in self-employment income may find that a solo 401(k) plan allows a higher contribution.

Solo 401(k) plans can be established as late as the last day of the business's tax year (generally December 31). However, you must establish the plan before you can make any elective deferrals. Therefore, if you wish to stagger your contributions throughout the year, it might be prudent to establish the plan earlier in the year.

### *Retirees' income*

A retired individual's overall tax planning should take into account the timing of distributions from retirement plans. Certain qualified retirement plans allow an individual to receive a lump-sum payment instead of staggered annual payments. The form of payment you choose should depend on your current and future income. It should also depend on whether the use of a lump-sum payment now outweighs the investment potential you'll forgo if you take only the minimum distribution and let the remainder continue growing tax deferred in your retirement account. Keep in mind that qualified retirement plan distributions are not considered net investment income for purposes of the net investment income tax.

### **- Roth IRA conversions**

Taxpayers should also consider the option of converting a traditional individual retirement account (IRA) into a Roth IRA account. Income limitations that had previously prohibited high-income individuals (those with an adjusted gross income over \$100,000) from converting traditional IRAs into Roth IRAs are now suspended.

The suspension of the income limitation delivers several advantages to taxpayers who are now able to convert traditional IRAs into Roth IRAs. Those advantages include tax-free investment growth (if distributions satisfy the "five-year holding period" criterion and certain other requirements) and no required minimum distributions during the owner's lifetime. However, the conversion will qualify as a "taxable event" in the year it occurs.

If after converting a traditional IRA into a Roth IRA, you change your mind, you can reverse your decision up until the due date of your 2013 tax return. Given the increase in tax rates since 2012, you'll want to think carefully about whether an IRA conversion is a wise choice in your circumstances. We strongly recommend that any taxes you end up owing as a result of the conversion be paid from funds outside the retirement account.



## *You can increase the likelihood of a greater rate of return by having a tax-efficient portfolio.*

### Portfolio income

Portfolio income encompasses investment income in the form of interest, dividends, royalties, and capital gains. This type of income is generally taxed at ordinary income tax rates, except for qualified dividends and long-term capital gains, which of course impacts your after-tax rate of return.

While there isn't much you can do to change the timing of interest or dividend payments from bonds and equity investments, you can increase the likelihood of a greater rate of return by having a tax-efficient portfolio. Ways of doing this include realigning your personal portfolio to include more tax-exempt municipal bonds and shifting less-tax-efficient investments into retirement accounts, where the assets will grow tax deferred. These tactics could be especially beneficial for individuals in higher tax brackets, since converting investment income into tax-exempt or tax-deferred income will have a significant impact on the after-tax rate of return. Unlike other types of portfolio income, tax-exempt municipal bond interest is not considered net investment income for purposes of the net investment income tax.

### Intra-family loans

Another portfolio income planning strategy involves lending money to family members. If, for instance, a family member is seeking a mortgage, you may want to consider acting as the lender. Currently, the minimum rate that you would be required to charge the mortgage recipient, the applicable federal rate, is very low — lower than the interest rate a financial institution would charge for a conventional loan.

The potential benefit for you, financially, is that the arrangement could very well generate a better rate of return than you'd obtain by keeping the money in a conventional investment. If the loan is secured by the residence, the borrower (i.e., your relative) might be able to deduct the interest. By obtaining a loan from you instead of through a financial institution, the borrower will pay considerably less interest expense in the long run.

### Capital gains and losses

Congress increased the favorable 15% long-term capital gains rate to 20% only for taxpayers in the top tax bracket (beginning in 2013). Short-term capital gains realized on the sale of investments held for less than a year are taxed at the same tax rate as ordinary income. The maximum tax rate for ordinary income increased from 35% to 39.6% at the beginning of 2013. Careful planning will help you limit the impact that the increased tax rate has on your capital gains.

A capital gain or loss can arise from the sale of an asset that is held for personal or investment purposes. It is important to note that losses on personal assets are not recognized for tax purposes.

Current-year capital losses will first be applied to offset capital gains that are in the same category as the losses. Any additional loss will then be applied to gains in the other category. For example, long-term capital losses will first be applied against long-term capital gains. Any remaining net capital loss in the long-term category will then be applied against net short-term capital gains.

## *Capital loss carryovers cannot be carried back to offset previously taxed capital gains.*

Therefore, you should employ a strategy that ensures that your carryover losses offset short-term capital gains when possible, regardless of whether those losses resulted from short-term or long-term transactions. If you have net capital losses overall in 2013, you may use up to \$3,000 of the capital loss to offset ordinary income, with the rest of the loss carried forward to offset capital gains in future years until it is fully diminished. Capital loss carryovers cannot be carried back to offset previously taxed capital gains.

As a result of stock market volatility, many taxpayers may find they have unused capital loss carryovers. Given the increased tax rates, these capital loss carryovers should be viewed collectively as an asset. If you still had a loss carryforward at the end of 2012, your previously generated losses will offset your capital gains in 2013 (which will be taxed at the current, higher rates), with the offset providing greater tax savings.

Before the tax year ends, you and your advisors should do a comprehensive review of your portfolio to determine what, if any, investments should be disposed of and whether it makes sense for you to sell those assets in 2013. For capital transactions that will produce capital losses, it might be best to proceed with those transactions before the end of 2013, whereas transactions that will result in a gain might best be deferred.

### **Commodities and collectibles**

When there is prolonged uncertainty in the stock market, commodities and collectibles tend to rise in popularity as investments. They include gold, silver, and various types of artwork.

Upon being sold, such investments garner less-favorable tax treatment than other capital assets if the seller has possessed the items for a “long-term” holding period. Specifically, commodities and collectibles held as direct investments are taxed at a rate of 28% if they’ve been owned for longer than 12 months — this in contrast to the more-favorable long-term capital gains rate of 20 percent. If, on the other hand, the seller has owned the investment for a “short-term” holding period, the tax rate is the same as for any other type of investment (i.e., the gain on the sale of the investment is taxed at ordinary tax rates).

If investing in commodities and collectibles interests you, but you’ve been deterred by the increased tax burden that such investments would put on your portfolio, you might want to consider indirect ownership through an investment vehicle that is designed specifically for these types of assets. For example, you can make long-term investments in equity-based exchange-traded mutual funds that focus on the economic returns of the corporations involved in the commodities industry.

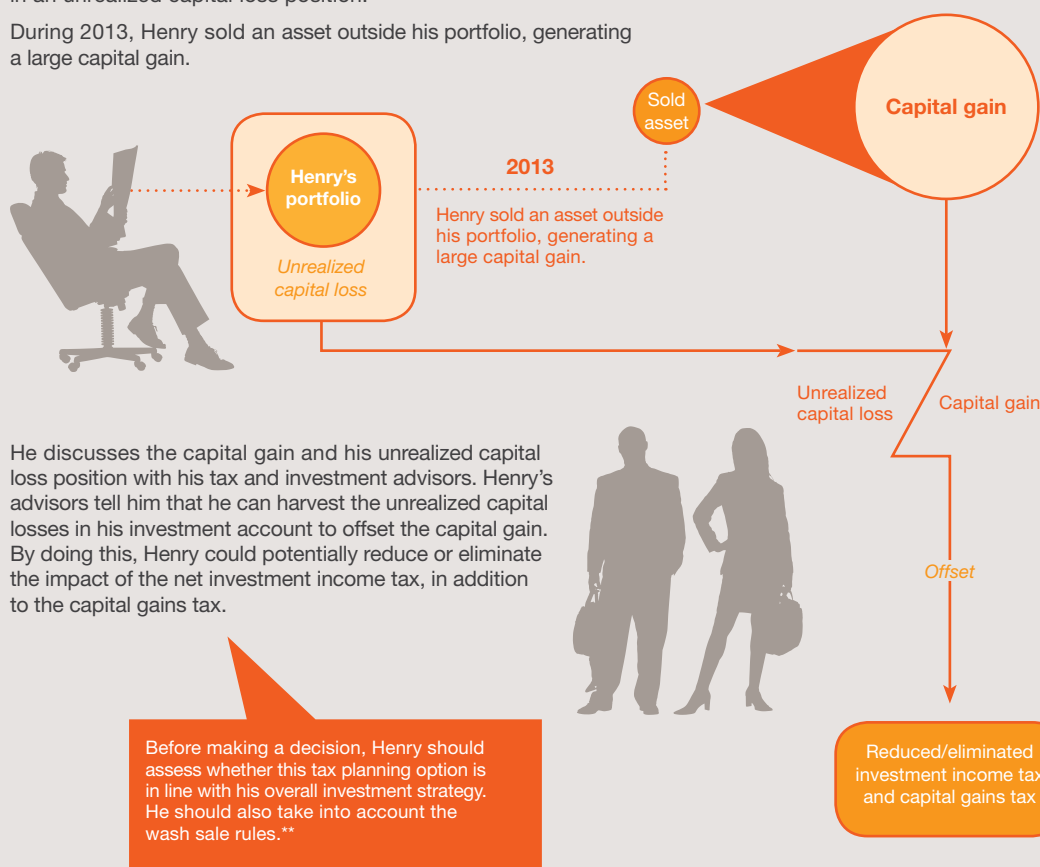
Although the tax implications of a transaction should not drive your investment decisions, you should always bear them in mind so that your overall investment strategy generates the greatest value for you.

## Harvesting unrealized capital losses

### A potential way to reduce your tax liability

Henry is reviewing his November 2013 monthly statement from his brokerage account. His statement reports that his portfolio is, overall, in an unrealized capital loss position.\*

During 2013, Henry sold an asset outside his portfolio, generating a large capital gain.



\* An unrealized capital loss arises when an asset hasn't yet been sold and hence (1) a loss has not yet occurred in reality and (2) there is a possibility that the asset could in fact increase in value, resulting in a capital gain upon sale.

\*\* The wash sale rules eliminate capital losses when the taxpayer repurchases the same asset within 30 days of sale.

## *Since no further tax-rate changes are currently scheduled, taxpayers should consider accelerating deductions.*

### **Deductions**

Many taxpayers chose to defer their deductions until 2013 in order to offset their 2013 income, which is taxable at the new, higher rates. Since no further tax-rate changes are currently scheduled, taxpayers should now consider taking the reverse course — accelerate deductions into 2013, to the extent that tax benefits can be obtained. Taxpayers should also keep a close eye on legislative initiatives aimed at limiting deductions for high-income taxpayers to 28 percent. If such legislation were to pass, high-income taxpayers might want to consider accelerating income and deductions into 2013, which would allow them to benefit from their deductions and also take advantage of the lower income tax rates.

### **Personal-exemption phase-out and itemized-deduction haircuts**

Limits on itemized deductions should be taken into consideration during the tax planning process. High-income taxpayers will need to pay particular attention to such limits in 2013, which will see the return of the personal-exemption and itemized-deduction phase-outs. These phase-outs were created during the Clinton administration to gradually reduce (“phase out”) personal exemptions and itemized deductions for high-income taxpayers.

Under the Bush administration, the phase-outs were put into reverse. For years, they were gradually rolled back so that in 2010 no taxpayer of any income level lost any of his or her personal exemptions or itemized deductions. Beginning in 2013, however, the limitations on itemized deductions and personal exemptions for high-income taxpayers returned.

Indeed, it's possible that the personal exemptions for certain high-income taxpayers will be disallowed completely if a person's income exceeds the threshold amount. As for the itemized-deduction phase-out, it will cause high-income taxpayers to lose a portion of their itemized deductions. The phase-out requires that taxpayers reduce their itemized deductions by 3% of the amount that their adjusted gross income exceeds a threshold (in 2013, \$250,000 for single filers and \$300,000 for married couples filing jointly), with a cap applied to ensure that taxpayers do not lose more than 80% of their itemized deductions. This phase-out does not apply to deductions claimed for medical expenses, investment interest expense, casualty losses, and gambling losses.

### **Itemized deductions**

The timing of your itemized deductions should play a role in your overall income tax planning. In the past, taxpayers have generally sought to accelerate year-end state income tax, real estate tax, and charitable contribution payments into the current year to obtain the maximum deduction for that particular year. This logic was applied in reverse in 2012, because rates were going up in 2013. However, with no further rate increases currently in sight, the conventional wisdom of accelerating deductions is something that taxpayers should now consider in assessing their tax planning options.

As state governments continue to face budgetary shortfalls and deficits, state income tax rates are on the rise. It is important that you consider the alternative minimum tax if you are planning to accelerate deductions such as real estate taxes, state tax payments, and miscellaneous itemized deductions. (The alternative minimum tax is discussed in greater detail later in this chapter.)

## *Gifts of appreciated property is an excellent strategy to maximize deductions.*

Charitable contribution planning should be done by year-end to ensure maximum deductibility and to determine if any charitable contributions should be deferred until 2014. To be deductible in the current year, your cash charitable contributions to public charities should not exceed 50% of your adjusted gross income. Similarly, if you plan to donate appreciated property to a public charity, the deduction cannot exceed 30% of your adjusted gross income. Any contributions that exceed these limits will be carried forward for up to five years. Gifting appreciated property is an excellent strategy to maximize deductions. It's important to speak with your tax advisor before making such donations to ensure that you have a valid deduction. (For more on tax considerations related to charitable contributions, please see this guide's chapter on charitable giving.)

### **Passive-activity losses: Using losses to offset your tax liability**

Taxpayers may take deductions for business and rental activities that they do not materially participate in but nonetheless derive income from (passive-activity income). However, such taxpayers are subject to stringent rules with respect to deducting losses that pass through to them from the business (i.e., the business that generates the passive-activity income). The passive-activity rules stipulate that a taxpayer is allowed to deduct losses stemming from passive activities (1) to the extent that he or she has passive income in the current year or (2) if it is the final year of the investment. When passive losses exceed passive income, unused passive losses are carried forward to offset future passive income.

Taxpayers who entered tax year 2013 with passive-activity loss carryforwards should consider pursuing investment strategies that preserve the carryforwards so that they offset future passive income. The overall effect of these strategies should be a decreased tax burden. However, these opportunities should be pursued only after you have carefully considered them in the context of your overall investment and business strategy.

### **Net operating losses: Carryback and carryforward options**

If you are in an overall loss position for the year after all your items of income and loss have been calculated, you may be entitled to a deduction for a net operating loss. Significant planning opportunities become available with net operating losses, because you have the option to offset the losses with prior or future income.

Typically, you are allowed to carry back your loss two years and then carry forward for 20 years any remaining unused loss. On your individual income tax return, however, you can forgo the carryback and make an irrevocable election to carry the loss forward. Before making this decision, you should carefully consider past and future tax rates, the amount and type of income that is available to offset the loss, and the impact of the alternative minimum tax.

Generally speaking, if tax rates are on the rise, it makes sense to carry the loss forward to the years of higher tax rates, assuming that you expect to have enough future income to use the loss fully. Bearing in mind the time value of money, however, you may decide it's more prudent to carry the loss back to years of higher income and get the refund now, rather than wait for future years' tax savings.

## Business deductions for owners and their companies

Strategic tax planning for business owners and their companies should incorporate all the strategies discussed in this chapter, in addition to tax savings techniques geared specifically to business entities. Many of the elections made at the entity level will have a significant impact not only on the company's tax burden, but also on the tax burden of individual shareholders and partners.

Some businesses often apply a deduction-acceleration strategy whereby they make what is known as an IRC §179 expense election for certain types of property. This allows the business to expense up to a certain amount of the cost of assets in the year they are placed into service, rather than depreciating the purchase(s) over time. That, in turn, enables the business to increase the deduction in the current year instead of expensing a portion of the cost over several years. For pass-through entities, choosing this type of election for the business's assets will directly impact the taxation of the individual owner. Whether such an election is wise this year should be considered in light of the increased personal income tax rates in 2013.

## Wash sale rule

Bear in mind the "wash sale" rule that applies to the disposition of an asset when a loss is recognized. You won't be allowed to deduct the loss if you repurchase the same security during the 30-day period before or after the sale date. This rule ensures that you will not be able to reinvest in an identical position of the investment while recognizing the benefit of a loss on your original investment. Note, however, that currently there are no such provisions for a transaction in which a gain is recognized.

## Employee Medicare surtax and the net investment income tax

The Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 created two new stand-alone taxes for higher-income taxpayers, effective for 2013.

One is a 0.9% surtax to the Medicare tax that is currently applied to earned income (i.e., employee compensation and self-employed earnings). This surtax increases the existing 1.45% employee Medicare tax to 2.35% and the 2.9% self-employed Medicare tax to 3.8% on compensation or self-employment income above certain thresholds.

The surtax applies to earned income over \$200,000 for single individuals and \$250,000 for married couples filing a joint tax return. Note that the thresholds apply only to earned income and not to modified adjusted gross income. Even though the surtax also applies to self-employment earnings, the deduction for self-employment taxes is not increased by the 0.9% surtax.

This tax is imposed on the employee and will have withholding and reporting requirements for employers.

The other stand-alone tax is a 3.8% tax on various types of investment income received by individuals, trusts, and estates (unearned income). This net investment income tax (NIIT) will be applied to net investment income (gross investment income less deductions allocable to that income) that is over certain thresholds. The threshold for single taxpayers is \$200,000; it is \$250,000 for married taxpayers filing jointly. For married individuals filing separately, the threshold is \$125,000.



## Net investment income tax (NIIT)

### How does it work?

Here are three scenarios:\*

The 3.8% NIIT applies to the lesser of net investment income or the taxpayer's modified adjusted gross income over the threshold amount.

Threshold amounts:

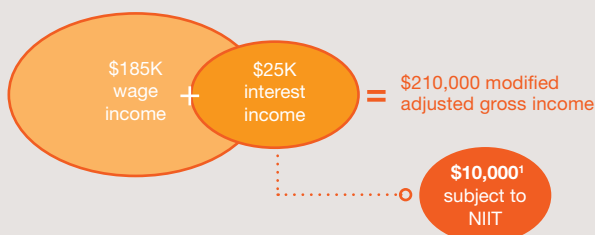
Single taxpayers: \$200,000

Married taxpayers filing jointly: \$250,000



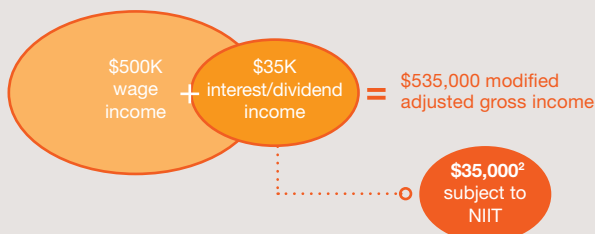
**1**

Tim is single. He has wage income of \$185,000 and interest income of \$25,000.



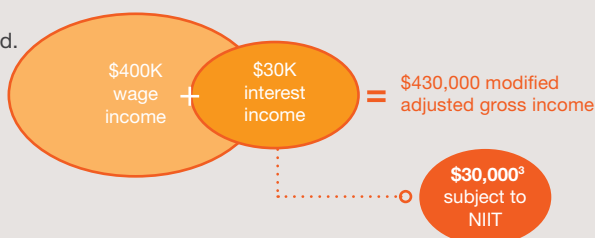
**2**

Jane is single. Her wage income is \$500,000. She has \$35,000 of interest and dividend income.



**3**

Mark and Sara are married. They have wage income of \$400,000 and interest income of \$30,000.



They sell their principal residence at a gain of \$200,000.

Capital gain from the sale of a primary residence is subject to NIIT only if the gain exceeds the current exclusion.

1 The NIIT on \$10,000 is the lesser of net investment income (\$25,000) or income above the threshold (\$10,000).

2 The NIIT on \$35,000 is the lesser of net investment income (\$35,000) or income above the threshold (\$335,000).

3 The NIIT on \$30,000 is the lesser of net investment income (\$30,000) or income above the threshold (\$180,000).

\* Assume that the taxpayers have no itemized deductions, for purposes of these examples.

## *The net investment income tax applies to individuals who might not be in the maximum income tax bracket.*

Investment income falls into three categories. The first category is traditional portfolio income such as interest, dividends, annuity income, royalties, and certain types of rental activities. The second category includes trade or business income from “passive investments,” as well as income from trading in financial instruments. The final category of investment income is gains from disposition of property, including capital gains from portfolio investments and capital gains from sales of investments that are passive activities (e.g., limited partnership interest).

Certain types of income are excluded from the definition of net investment income:

- Earned income — wages and self-employment income (subject to the 0.9% Medicare surtax)
- Active trade or business income
- Distributions from qualified retirement plans or IRAs
- Interest on municipal bonds
- Excludable portion of gain on the sale of a primary residence

Note that while earned income, active business income, and retirement plan distributions are not subject to the net investment income tax, they do increase adjusted gross income (increasing the likelihood that the tax will apply).

After combining income from the three categories (losses from one category do not reduce income from another category), you are allowed to make certain deductions so that you arrive at an amount that encompasses your net investment income.

The 3.8% net investment income tax then applies to the lesser of (1) net investment income or (2) the excess of a taxpayer’s modified adjusted gross income over an applicable threshold amount. Note that the threshold level is before itemized deductions. Further, the net investment income tax applies to individuals who might not be in the maximum income tax bracket.

### *Alternative minimum tax*

The alternative minimum tax (AMT) often causes confusion and concern for many taxpayers. The AMT was instituted to ensure that high-income taxpayers paid at least a minimum amount of tax each year. To this end, a parallel tax calculation was created, one that incorporated the regular tax system, along with certain adjustments called “tax preference and adjustment items.”

One of the most significant adjustments in the AMT calculation is the disallowance of certain itemized deductions, including state and local income taxes and miscellaneous itemized deductions. Other items that must be adjusted for AMT purposes include tax-exempt interest on certain private-activity bonds; the bargain element of incentive stock options; and depreciation, which must be recalculated for AMT purposes over a longer recovery period. The maximum tax rate that can be applied to your AMT income is 28 percent. It is important to note that although the AMT rate is lower than the current regular tax rates, this lower rate is applied to a higher taxable amount, often resulting in an increased overall tax liability. Long-term capital gains that are taxed at the lower 20% rate for regular tax purposes continue to be taxed at the same preferential rate under the AMT structure.

## *The AMT needs to be considered when you're determining whether income or deductions should be accelerated or deferred.*

Oftentimes, taxpayers who find they are subject to the AMT have significant income from long-term capital gains and qualified dividends that is being taxed at the preferential rates, or they may have significant adjustments for the other reasons noted earlier. Taxpayers who live in states with a high income tax rate (e.g., California and New York) often find themselves paying AMT as a result. As various states attempt to balance their budgets, they too may raise their tax rates. These potential rate increases could have a direct impact on your overall federal income tax liability if they expose you to the AMT.

Most years Congress has addressed the exemption that is built into the AMT calculation. If the exemption amount is not indexed for inflation each year, then the AMT ends up affecting not only high-income taxpayers (as was the original purpose), but also many other taxpayers too. This adjustment of the exemption amount is known as an "AMT patch."

The AMT patch provides an increased AMT exemption for taxpayers. The fiscal cliff legislation added an automatic indexing feature to the AMT law to prevent the unintended consequence of causing ever-increasing numbers of taxpayers to pay the AMT.

Some of the tax proposals, including those in President Obama's budget for fiscal year 2014, could have a significant impact on the AMT. Although the fiscal cliff legislation addressed the exemption problem, many upper middleclass taxpayers may still fall under the AMT tax regime. However, for some taxpayers, the increase in regular income tax rates reduces the likelihood of their paying the AMT.

As a result of the various tax changes in 2013, it is more important than ever to be actively engaged in your tax planning so that you can understand how the AMT will affect your tax liability in light of the tax changes. As noted earlier in this chapter, the AMT needs to be considered when you're determining whether income or deductions should be accelerated or deferred. The key to AMT planning is finding the breakeven point where your regular tax liability and your AMT liability are equal. Knowing where that point is will help you decide whether it makes sense to accelerate additional income or deductions into the current year.

Once you are subject to the AMT, the most you will receive is a 28% benefit for your deductions. Accelerating the deductions that are considered AMT preference items will not result in any additional benefit for taxpayers who are subject to the AMT. If you are able to accelerate income without moving yourself out of the AMT, you could benefit from paying tax at a rate of, at most, 28% instead of the ordinary tax rate that's based on your income level.

### ***Kiddie tax***

Income-shifting generally involves transferring income-producing property from a high-income taxpayer to someone who is taxed at a lower rate. For high-income individuals, shifting income to children or other family members who are in lower tax brackets generally proves an effective long-term planning strategy. Bear in mind, however, that children under age 18 and fulltime students under age 24 will be taxed at the parent's higher income tax rate on investment income that exceeds a threshold amount (for 2013 this amount is \$2,000, potentially preventing the shifting of such income to children from resulting in any tax savings).

## *Many foreign jurisdictions impose a tax withholding requirement on investment income earned by nonresidents of the jurisdiction.*

### ***Household employment taxes***

Many households hire individuals to do various kinds of work. However, the personal tax effects and filing requirements of hiring household employees are often overlooked. Determining whether, from a tax perspective, these individuals are considered employees or independent contractors depends on the type of services they render and the control that you, as the employer, have over how they perform those services. If you pay a household employee more than the annual limit of cash wages (for 2013 this amount is \$1,800), you will be liable for Social Security and Medicare taxes for that individual. Those tax payments are remitted when you file your individual income tax return and may need to be factored into your quarterly estimated tax payments if you are to avoid underpayment penalties.

You should also take care to remember informational filings (such as W-2s and 1099s) that you are required to file with the IRS and present to service providers, including household employees. Additionally, state unemployment tax filings are often required for household help.

### ***Foreign investments: Income and reporting***

Many US investors include foreign direct investments in their overall investment portfolio. One benefit to including foreign assets in your portfolio is to participate in the upside of the globalization of the economy. These investments are permitted under US tax law but require additional reporting and compliance. It is important, therefore, that you factor this requirement into your tax planning activities.

Since all US taxpayers are subject to tax on their worldwide income, the interest, dividends, capital gains, and other income earned through foreign investments is reported on an individual's tax return. Realize, also, that many foreign jurisdictions impose a tax withholding requirement on investment income earned by nonresidents of the jurisdiction. Therefore, your cash flow from such returns would be subject to reduction by the amount of the withholding. However, the US tax code does permit you a credit for such amounts that are withheld and paid to a foreign jurisdiction. As long as your net foreign income is positive and you have an actual federal tax liability, you will be entitled to the credit. It is not a credit in the form of a refund — it is useable only to the extent that you owe actual tax. The other positive aspect of this credit is that it can be applied against the alternative minimum tax.

Not only do US taxpayers have to report income from such foreign investments, but many of them are also required to file informational returns disclosing the ownership and value of such foreign assets. There are two common forms that must be used to disclose foreign asset holdings. One is Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). You need to file it if you have a financial interest in or signature authority over foreign financial accounts with aggregate balances greater than \$10,000. In filing this report, you are not required to pay any tax (the income amounts are included on your individual income tax return), but you do have to report on an annual basis the maximum balance for each account. The definition of a foreign “account” for purposes of this report is very broad, and many investments that might not seem as though they need to be disclosed do in fact have to be reported.

In addition, individual taxpayers may be required to file Form 8938, *Statement of Specified Foreign Financial Assets*. This requirement is one of the Foreign Account Tax Compliance Act (FATCA) offshore anti-tax-evasion provisions that resulted from the 2010 Hiring Incentives to Restore Employment Act (HIRE). It stipulates that taxpayers must file Form 8938 with their individual tax return if they hold foreign financial assets that exceed certain thresholds (for example, a US citizen and resident who is married and holds foreign assets exceeding \$100,000). The definition of foreign financial asset is broader than that of the FBAR form and may include assets such as foreign pensions, hedge funds, stocks, and real estate.

The consequences of not complying with the FBAR and FATCA disclosure requirements are steep and may include both civil and criminal penalties. To avoid these penalties, consult a tax advisor before making foreign investment decisions and have a discussion with your tax advisor about all your current holdings to ensure that you are disclosing all appropriate items.

## **Conclusion**

For high-net-worth individuals, tax planning done well requires careful attention across a wide range of areas, some of which we've discussed in this chapter. These areas should be considered not only within the economic and legislative context of the next few years, but also with the long view in mind. In taking this approach, the decisions you and your tax advisors make now should be instrumental in preserving your wealth — not just for your own future, but for that of the next generation as well.



A woman with brown hair tied back, wearing a white button-down shirt, is smiling while talking on a black corded telephone. She is holding a newspaper in her left hand, which has a section titled 'FONDOS COMUNES DE INVERSION'. She is standing in a kitchen, with shelves of pots and pans visible in the background. In the foreground, there is a desk with a binder, papers, and a pair of glasses.

# *Managing your investments*





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**Ch2** Your investment strategy is an integral component of your overall wealth management plan.

Managing your personal investments and planning for your family's ongoing financial security can be challenging in the best of conditions. Today, there's the additional challenge of accomplishing those tasks against the backdrop of a slow-growing economy and still-volatile market — both of which are affected by political and economic developments around the world. In this dynamic atmosphere, it's important to have a globally diversified investment strategy that will keep you on an even keel while also letting you remain flexible enough to capitalize on new opportunities when and where they arise. In light of recent tax law changes, investors should also revisit their investment portfolio to make sure it is still tax efficient.

***Building your investment plan***

In devising your personal investment plan, you'll want to consider taking the following key steps:

- Assemble an investment advisory team.
- Establish goals and assess constraints.
- Determine the appropriate risk/return tradeoff to meet your goals.
- Allocate assets and implement your investment strategy.
- Review your investment performance and rebalance your portfolio accordingly.

## Assemble your investment advisory team

When you start building an investment portfolio, your investment advisory team may consist of just you, your spouse/partner, and one trusted advisor. As your wealth grows, your investment team may need to expand to include additional advisors.

The investment advisors on your team should be trained and experienced in financial planning. They should also have a full awareness of your overall wealth management goals. To obtain this, your investment advisors should consult regularly with your other wealth management advisors, such as your tax accountant and estate attorney. Careful coordination and communication among these various parties are essential to successful wealth management.

Members of your investment team may include money managers, custodians, financial counselors, accountants, and even your adult children, among other people:

- **Money managers** can help the team execute a specific investment strategy. They may include brokers, asset managers, mutual fund managers, or managers of exchange-traded funds.
- **Custodians** are responsible for the safekeeping of a portfolio's investment assets and for providing the team with performance reports.
- **Financial counselors** can help with risk assessment and retirement analysis.
- **Accountants** should lead the tax-strategy aspect of your investment planning.
- **Adult children** may be encouraged to participate so that they'll develop the knowledge and skills necessary for dealing with the family investments, as well as learn to work cooperatively in reaching wealth management decisions.

As your investment advisory team grows, you'll want to consider appointing one of its members to the position of team manager. That person should work with you and your other investment advisors to maintain/update your investment plan and coordinate its execution. Ideally, the team manager will be objective and collaborative. He or she should also have broad investment experience and be knowledgeable about the dynamics of today's financial markets and legislative developments.

It is recommended that the team manager also be a credentialed individual, such as a chartered financial analyst, certified financial planner, general securities representative, or certified public accountant who specializes in personal finance. Certifications help to ensure that there is a baseline of knowledge on your team, as well as the fulfillment of continuing education requirements, including those that will help your team manager stay abreast of the changing financial and legislative landscape. Above all, the manager of your investment team should be someone whose advice you trust and who is adept at keeping the team working cohesively. He or she should also keep you updated on any changes in your investment plan and explain how they align with your wealth management goals.

## Determine your goals and constraints

In working with your investment advisory team to set your investment goals, be sure that you consider a mix of (1) near-term objectives, such as funding the purchase of a vacation home within a year or two, and (2) long-term goals, such as funding your financial independence, your children's or grandchildren's education, inheritances, and even charitable bequests.

Specific investment strategies — either alone or in combination — can help you achieve these goals. Those strategies may include investing to grow capital, preserve capital, or generate income.

# Fast-forward to the future

Early retirement = early (and big) savings commitment

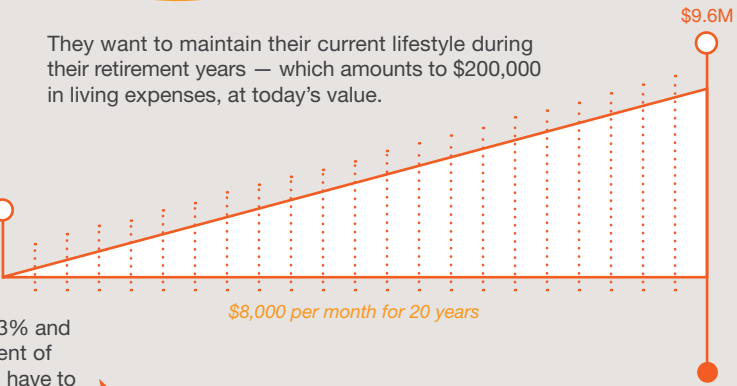
Kent and Allison are a married couple who wish to retire in 20 years, at the age of sixty.

How much must we save to retire comfortably when we turn sixty?



They want to maintain their current lifestyle during their retirement years — which amounts to \$200,000 in living expenses, at today's value.

\$1.6M current assets  
3% inflation  
6.5% return on investment



Assuming an inflation rate of 3% and a nominal return on investment of 6.5%, Kent and Allison would have to contribute around \$8,000 per month over the next 20 years to fully fund their expected retirement.

Kent and Allison retire with 102% of their projected retirement costs met.

Current annual living expense*	\$200,000
Current assets	\$1,600,000
Annual inflation rate	3.0%
Number of years until retirement	20
Length of retirement	30
Nominal return on investment	6.5%
Projected retirement cost	\$18,062,441
Monthly contribution needed to fund cost	\$8,000

\* In today's dollars

## *There is much more to consider than just the calculus of taking more risk to achieve higher returns.*

Don't forget to take into account the constraints you face in implementing your strategy. Typical constraints include dollars available to invest, limited risk tolerance (discussed in the following pages), and liquidity needs. Taxes and transaction costs must also be considered.

### **Investment policy statement**

A formal part of an investment strategy often includes an investment policy statement (IPS). An IPS describes a person's investment strategy in some detail. Your team manager might suggest including multiple sub-IPSs within the main IPS. For example, you might create one statement/strategy to address your lifestyle needs, one for a family foundation, another for your children's assets, and so on. Once the IPS is created, your investment manager should work with the members of your investment advisory team to implement and monitor the strategy. It is very important that you also periodically monitor your advisor's adherence to the IPS and benchmark the progress toward your goals.

### **Assess the risk/return tradeoff**

The next step is to focus on the risk/return tradeoff. There is much more to consider than just the calculus of taking more risk to achieve higher returns. It is also important to bear in mind that your "real" investment return (nominal return minus taxes and inflation) is the true measure of your wealth gain. You'll want to be sure to take that into consideration in the context of various types of risk and to revisit the real return in light of potential changes in your marginal tax rate.

When it comes to risk, most people focus on return volatility. However, that is just one among a variety of risks, including market risk, business risk, and inflation, to name just a few. Risk really comes down to one factor — how much of your portfolio you are willing to put at risk of loss in order to achieve a desired rate of return. Even if you keep your investments in cash, you are still subject to risk of loss due to inflation. Because investors differ in how they weigh particular risks, no single portfolio fits all investors. That said, most investors generally consider the following core risk factors when making investment decisions.

### **Required risk**

A certain amount of risk is needed to achieve a particular investment goal (as well as your investment goals overall). For example, if you want to maintain your current lifestyle, you should run an analysis of your future cash flow, whereupon you may determine that you'll need to achieve an overall real return of 5% to meet your specific lifestyle goals.

Analyzing the required risk to meet your goals will help you quantify the requisite risk/return tradeoff for meeting those goals, allowing you to determine whether they're achievable given the financial risk you would be required to take. If you consider the required risk too high, you can revise your goals so that they stay at a risk level acceptable to you.

## *An investor's personal tolerance of risk is perhaps most easily described as the level of risk that the person can withstand and still sleep well at night.*

### **Risk capacity**

Assessing your risk capacity entails looking at the additional risk (beyond required risk) that you could assume without jeopardizing your goals. For instance, a 5% rate of real return might enable you to meet your goals with relative ease. If that's the case, you might want to consider whether you would still be able to meet those goals if you were achieving a real return of 4 or 3 percent.

Making this determination will reveal the additional amount of cushion that would protect you against a change in investment assumptions, such as lower-than-expected returns, higher-than-expected retirement costs, or lower-than-expected income flows. Assessing your risk capacity can also help you determine the extent to which decreasing your targeted return may reduce the risk exposure of your portfolio, provided that this fits within the context of your plan.

One common method of measuring risk capacity is the Monte Carlo analysis. This analysis runs a set of assumptions through multiple simulations using random variables, such as rate of return, to measure the probable success or outcome. Commonly, the Monte Carlo analysis is used to test assumptions in all types of hypothetical market conditions and based on all types of returns. Theoretically, the higher the success rate, the more likely you are to achieve your stated investment

goals, regardless of the market environment going forward. If you have excess risk capacity, creating a more conservative investment portfolio — and thereby reducing the risk — could improve the success rate in a Monte Carlo analysis by reducing the probability and impact of large loss scenarios. Your wealth management team will know how to run the appropriate simulations and draw reasonable conclusions.

### **Risk tolerance**

An investor's personal tolerance of risk is perhaps most easily described as the level of risk that the person can withstand and still sleep well at night. Compared with required risk and risk capacity, risk tolerance is more abstract, since it has a strong psychological dimension. It deals with a person's willingness to accept short-term losses in the effort to achieve a long-term return.

An individual's risk tolerance can change greatly over the years, particularly as the timeframe for achieving a stated goal contracts and the resilience of an investment portfolio wanes. The past several years, in particular, have put the risk tolerance of investors to the test. Swings in the market and sustained periods of political and economic uncertainty can unsettle even the most seasoned and experienced investor, further underscoring the need to have a solid investment plan that will see you through the ups and the downs of the market.

## Allocate your assets wisely

Asset allocation is the underlying principle of modern portfolio theory. It lays out a structured framework that will keep you from chasing returns or overreacting to unexpected market conditions. But as everyone knows, even the best framework won't alert you to changes in the environment — a key reason for assembling a solid investment management team. Studies have consistently shown that trying to pick the right entry and exit points in the market rarely, if ever, works. The same holds true of investment fads. A vigilant investment team can help you avoid these wrong turns by recommending changes to your portfolio that are tactical and strategic, rather than changes that are reactive or based on guesswork about market timing.

## Asset-class selection

Asset classes are groups of various investments with similar characteristics. Since various asset classes will react differently to similar economic conditions, it is possible to combine several asset classes that do not have closely related performances. This creates a portfolio return that will be less than the return of the best-performing asset class but above that of the worst-performing class. Given the ongoing uncertainty about future market conditions, this approach reduces the overall volatility of a portfolio while improving the likelihood of a more stable long-term return.

Most investment managers acknowledge that decisions about asset allocation account for over 80% of performance variability over time and are much more important than the selection of individual securities and other risk-control factors, such as timing. Therefore, it makes more sense to concentrate on the correct asset allocation and asset-class selection to meet your goals, rather than concentrating on seeking the individual security that might produce the most desired performance.

## Asset allocation as diversification

Asset allocation is a form of diversification, since you're not putting all your eggs in one investment basket. By investing in several asset classes, you are reducing the level of risk that is required to achieve a desired rate of return. However, you also need to diversify within each of your asset classes, making sure they include an adequate mix of individual securities or bonds.

For example, if you owned one cash account, one intermediate-term government bond, and one stock, your portfolio would be allocated but not diversified. Greater diversification can be achieved by owning a portfolio of bonds or stocks that can be obtained through the use of money managers or via the purchase of funds that cover the different characteristics of investments within a specific asset class.

One common method of bond diversification for investors as they approach retirement is known as bond laddering whereby an investor staggers the maturity of the bonds in his or her portfolio. This method (1) reduces interest rate risk by having an investor's portfolio hold the bonds until they mature and (2) will commonly match the investor's cash flow needs with the bonds' value upon maturity.

Investing in short-term-bond funds (here "short term" means less than one year) might provide diversification among numerous short-term bonds, but it does not address diversification within the bond category overall. Further diversification can be achieved by also investing the targeted percentage in intermediate, long-term, municipal, corporate, or Treasury bonds, to name just a few.



# Global diversification

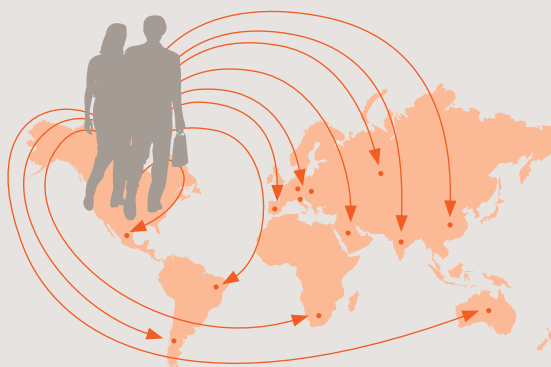
## Investing internationally

An important consideration after reviewing your asset allocation and risk profile is how you will invest internationally.

Many investors have a tendency to invest in what they know. As a result, they may overlook opportunities for diversification through international investing.

In reality, much of the world market capitalization for equity investments is outside the United States, making cross-border investing an important component of diversification and participation in global market returns.

There are many methods for investing internationally, with varying levels of complexity and risk.



**Your investment opportunities can cross borders**

### Commonly used means of international investment

- American depository receipts
- Exchange-traded funds
- Mutual funds
- Direct investment in foreign securities
- Investment via foreign entities such as investment partnerships and hedge funds
- Passive foreign investment companies
- Controlled foreign corporations

As with any investment, there are risks to international investments that you should consider in the context of your overall investment strategy.

### Common risks

- Currency risk when investments are traded or denominated in their local currency
- Political and social risks
- Regulatory risk
- Liquidity risk due to potentially low trading volume
- Potentially higher costs and fees

Pursued wisely, international investments can efficiently and effectively give your portfolio further diversification within the foreign asset classes in your overall asset allocation.

Diversification is an important way to mitigate risk when you invest internationally.

## *When you rebalance your portfolio, you sell investments at potential highs in the market and purchase other investments at potential lows.*

### Strategic and tactical allocation

Two common types of asset-allocation approaches are strategic allocation and tactical allocation.

- **Strategic allocation:** This technique seeks long-term results by sticking to predefined levels for each asset class — regardless of the market environment and regular rebalancing — to ensure that the overall portfolio stays within predefined parameters of the targeted asset allocation. Strategic allocation is founded on modern capital market theory and assumes that additional economic analysis won't consistently promote higher investment results over the long term.
- **Tactical allocation:** This technique is more opportunistic than strategic allocation and takes the overall market environment into consideration, including economic factors for each asset class (e.g., valuation), the trading of asset classes below historical levels, the current interest rate environment, and other market conditions.

Both approaches should be considered and deployed as appropriate within the context of an individual's or family's overall investment plan and long-term wealth management goals.

### Overall goals and risk management considerations vis-à-vis asset allocation

When determining the correct asset allocation in the context of meeting goals such as retirement objectives, don't forget to incorporate the basic rules of personal liquidity risk management: Have a liquid cash reserve available to pay living expenses in the event of a personal crisis or a down market. This liquidity helps give you the

wherewithal to stick to your investment plan during down and volatile markets. Advisors differ on how large a cash reserve you should maintain. Generally, however, it is considered prudent to have enough cash on hand to cover one to three years' living expenses, depending on your circumstances.

Also, make sure you are looking at your investment portfolio as a whole when considering the correct asset allocation for your needs. It can be tempting to put brokers and investment advisors in competition with one another as they seek accounts that provide the highest return. However, this approach often leads to inefficiencies and increased fees, with multiple accounts having separate asset allocations and varying levels of risk while serving similar objectives.

To avoid this situation, make sure you draw on your full team to determine a cohesive investment strategy and asset allocation suitable for meeting your various goals. It is important that different advisors or team members work together to devise your overall allocation. In addition, having a trusted advisor who can monitor your plan and coordinate the advisory team's efforts overall will help you achieve greater efficiency and a reduced level of risk.

### Review your portfolio's performance

It is likely that your personal financial goals will change as time passes. Therefore, revisit your wealth management plan annually to decide whether your investment portfolio is still suited for achieving your goals or whether changes should be made.

## Rebalancing your portfolio

Making changes often entails rebalancing your portfolio. Rebalancing will be necessary as new cash is added to the portfolio or as the portfolio grows disproportionately for each asset class. Both of these circumstances will change the overall allocation, which can, in turn, materially change the overall risk level of the portfolio.

Rebalancing also effectively sells the excess from the portfolio's winning asset classes each year and purchases the losing asset classes. Put another way, when you rebalance your portfolio, you sell investments at potential highs in the market and purchase other investments at potential lows. This is often counterintuitive, as many investors want to buy the best-performing assets in a given year in an effort to chase returns. However, studies have shown that the "hot" asset classes in a given year rarely repeat their strong performance in subsequent years. By rebalancing your portfolio, you'll not only be restoring it to the original asset allocation established during the initial planning process but may also be enhancing your returns along the way.

Rebalancing your portfolio also presents the perfect occasion to monitor your holdings and compare your investments with their respective benchmarks or asset classes. However, make sure you are taking into account more than just historical rates of return. Other important factors to consider include fund size, manager tenure, fees and expenses, risk-adjusted performance, the composition of underlying securities, and the taxation of the investment. Monitoring your portfolio (either quarterly or annually) is an important step that you and your team should be careful not to skip.

## Fees and expenses

While it is reasonable to expect to incur some level of expense and fees while investing, you want to keep an eye on the effect that these costs have on the overall return and performance of your portfolio. The impact can be considerable. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 highlights the need for fiduciaries to monitor and evaluate the fees charged in retirement plans. Your team should take the same diligent approach to your portfolio.

There are many types of fees you'll want to be alert to when reviewing your portfolio:

- **12b-1 fees:** These fees are applied toward fund advertising and marketing, primarily to compensate fee-based advisors who provide services for the fund's shareholders. These fees can range from zero to 0.75% of the assets' value.
- **Annual account fee:** This is sometimes charged by brokerage houses to cover required IRS reporting and filing costs.
- **Investment management fee:** This fee is charged by an investment advisor who is overseeing a personal portfolio. It is commonly charged as a percentage of assets or as an hourly rate by fee-only planners.
- **Other expenses:** These include indirect costs such as those associated with accounting, administration, recordkeeping, and legal work, as well as fees for separately managed funds.
- **Management fees:** These are part of a fund's annual operating expenses and are used to compensate the fund manager.

## *Asset location entails determining the best “place” for you to own a particular investment, given the objectives you want that investment to meet.*

- **Frontload fee:** This is a commission charged up front when you invest in a mutual fund. It is in addition to the fund’s ongoing operating costs. For example, a mutual fund may charge you a 5% frontload fee for investing in the fund. If you invest \$10,000, then \$500 will be taken out of the investment up front, and the remaining \$9,500 will be invested in the fund. This fund will have to generate a higher rate of return if it is to equal the return you receive from a no-load fund, assuming that all other fees are equal.
- **Deferred-load fee:** In contrast to a frontload fee, a deferred-load or redemption fee applies to certain funds if you sell them within a stated time frame. Such fees are often meant to discourage short-term investing in a fund.
- **Transaction costs:** These are the costs associated with buying and selling securities, either within a fund or directly. They are what a brokerage house charges to trade a bond or security and typically range from \$5 to \$50 but may be higher than that.

### *Achieving tax efficiencies through strategic asset location*

Up to this point we have not said much about the impact of income taxes on investment decisions. Make no mistake: Income taxes matter in the investment process. With the recent rise in tax rates for high-income taxpayers and the introduction of the net investment income tax, income taxes have come to the forefront in many investment discussions. Indeed, it is always important — not just now but also in general — to consider how changing rates affect your overall investment strategy and the location of those investments.

As discussed in chapter 1 of this guide, the marginal income tax rate has increased from 35% to 39.6% for married couples who file jointly and have combined taxable income above \$450,000 and for unmarried individuals with income above \$400,000.

There is also the new 3.8% net investment income tax for single taxpayers with modified adjusted gross income over \$200,000 and married couples with modified adjusted gross income over \$250,000 who are filing jointly.

It is important, therefore, that your decisions about asset location take into account the effect that these income taxes have on your portfolio return. One way to mitigate the impact is by achieving tax efficiencies via strategic asset location.

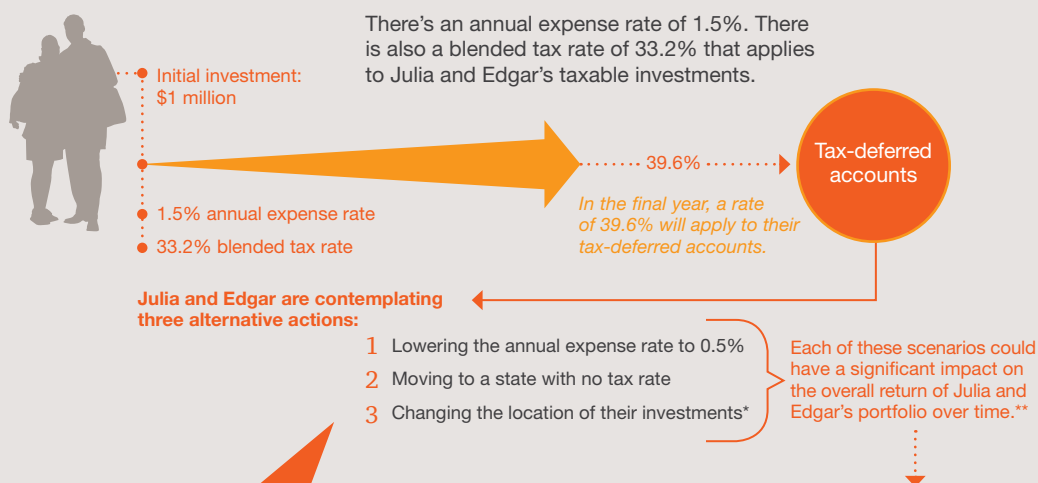
Essentially, asset location entails determining the best “place” for you to own a particular investment, given the objectives you want that investment to meet. The investments of wealthy individuals are rarely held in just one place — that is, they are rarely kept in just one account or entity. Instead, they’re usually held in different buckets that have been established to help implement the investor’s financial and wealth transfer planning over time.

Each investment bucket is established for a particular purpose and therefore requires a specific investment strategy. A bucket can be invested in either taxable or tax-deferred accounts that delay taxation — such as individual retirement accounts (IRAs), 401(k)s, and deferred compensation plans. These types of accounts have become increasingly attractive to investors over the past year due to the highest

## Weighing alternative investment scenarios

### How different strategies play out over time

Julia and Edgar make an initial portfolio investment of \$1 million, which grows at a rate of 6.5% annually.



This third scenario would better enable Julia and Edgar to use more-favorable rates on capital gains, tax-free investments, and tax-deferred accounts to obtain a blended federal rate of 18.2% annually and 39.6% in the final year for their retirement accounts.

Year	Current situation	Lower fee	No state taxes	Asset relocation*
0	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
5	\$1,160,455	\$1,195,044	\$1,177,420	\$1,193,595
10	\$1,348,560	\$1,430,981	\$1,388,155	\$1,428,924
25	\$2,133,060	\$2,483,990	\$2,290,859	\$2,487,214
50	\$4,694,240	\$6,449,478	\$5,386,757	\$6,477,699

\* Asset location entails determining the best bucket or "place" to own a particular investment in order to achieve a certain investment objective (e.g., a bucket that's invested in tax-deferred accounts). Depending on what the investment objective is, it may make sense at times to change the location/buckets of certain assets (e.g., change the location to a taxable account). This is known as asset relocation.

\*\* This example ignores the impact of inflation.

marginal tax rate increasing from 35% to 39.6% at the start of 2013. Another attractive aspect of deferral accounts is that they are not subject to the potential net investment income tax of 3.8% on annual investment income, whereas earnings in taxable accounts may be subject to that tax. They may also be invested in accounts such as Roth IRAs and college savings plans, which offer potentially tax-free investment opportunities and may have different time horizons.

Which investments to own inside these accounts depends on the investment purpose of a given 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 also generate capital appreciation that could be taxed at ordinary income rates (if held less than one year) or at favorable tax rates 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 upon distribution.

Asset location decisions are often very complicated and must take into account many variables besides income taxes. Other considerations — such as estate- and gift-planning goals, income and liquidity needs, age of the investor, and the portfolio's investment time horizon — will all need to be taken into account before you decide which asset location is likely to produce the most tax-efficient investment environment and still meet your goals.

### **Investor behavior**

Although investment planning and decision-making may follow a logical sequence, an investor's psychology can disrupt even the best-laid plans.

Generally speaking, investor behavior tends to mirror the current state of the economy and the business cycle: If things are looking good, investors tend to be positive; if things start to take a turn for the worse, their attitudes turn negative. Most investors focus on the present (present job situation, current economy, recent stock movements, and so on), making investment decisions that can be nearsighted and counterproductive. Investors without a specific investment plan tend to underperform the index and a comparable diversified portfolio because an individual investor's inclination generally is to sell at market lows and buy at market highs.

Ideally, an investor is slightly ahead of the crowd, selling before markets fall and buying before they begin to rise. Unfortunately, predicting market movements and their exact timing is extremely difficult. A strategy that many investment advisors consider more reliable — and one that has proven effective in managing risk and capturing reasonable returns — is a systematic asset allocation that is based on the time horizon associated with a particular investment goal. This, combined with a well-documented strategy (or investment policy statement) and tactical rebalancing, can go a long way toward keeping your investment behavior and game plan on track.

### **Conclusion**

Investment planning is a complex undertaking that, while rooted in fundamental principles, must be approached differently in the case of each individual's or family's particular wealth management needs and expectations. By working closely with your team of advisors, you can help ensure that your investment plan adequately supports your goals, both today and in the long term.



# *Charitable giving*





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**Ch3** Charitable structures and wealth transfer strategies can complement each other in an overall wealth management plan.

Without private philanthropy, few charitable organizations would survive. That they do survive brings important benefits to society. Planned properly, charitable giving can also bring personal benefits to you, the donor, serving as an effective tool in your overall wealth management strategy. The primary way it does this is by offering a tax-efficient means to transfer wealth. You may, for instance, find that making a philanthropic donation is an attractive alternative to dealing with a large, appreciated portfolio of securities. Other individuals may look to philanthropic activity as a potential income stream. And then some people may simply wish to create a legacy of family giving, with tax benefits being a secondary though important consideration. There are a variety of ways to achieve these objectives. Before pursuing a particular course of charitable giving, an individual or family should consider the available approaches carefully.

## *Donor-advised funds have become popular among people who want a greater sense of control over how their donations are being applied.*

### **Charitable structures**

There are a number of commonly used charitable structures. Each carries different tax and nontax considerations. Therefore, it is important that you not only align your charitable goals with the structure that best supports them, but also give full consideration to the related tax and non-tax implications.

### **Public charities**

A public charity is a tax-exempt organization created and operated exclusively for religious, charitable, scientific, literary, or educational purposes. A public charity can receive broad public support, be operated to support another public charity, or be a religious institution, school, or hospital.

Generally, gifts of cash to public charities are fully deductible up to 50% of a donor's adjusted gross income (AGI). Gifts of appreciated securities are usually deductible up to 30% of a donor's AGI.\* To the extent that the amount of a specific year's charitable gift(s) exceeds the AGI thresholds, excess contribution amounts are carried forward and are deductible for up to five years following the year of the gift.

### **Community foundations**

Large metropolitan areas often have community foundations that accept donations for the general benefit of the people in those communities. Community foundations serve multiple charitable organizations, allowing a foundation to meet diverse needs across a community. For income tax purposes, gifts to a community foundation are treated the same way as gifts to public charities.

Many charities strongly prefer gifts of cash or publicly traded securities. They are apt to place explicit or practical restrictions on receiving gifts of "unusual" assets, such as real estate, business interests, personal property, precious metals, and intellectual property (e.g., copyrights and patents). Community foundations, however, may be more willing to accept — and be better equipped to deal with — gifts of this nature, due to the more-local, personalized service they provide.

### **Donor-advised funds**

Many mutual fund groups, investment firms, large banks, brokerage houses, and community foundations have established donor-advised funds. These funds have become popular among people who want a greater sense of control over how their donations are being applied, since such funds enable donors to request that their public charity donations be used in specified ways.

While donors do not have the legal right to insist that their donated funds be used in a particular manner, most charities oblige the donor's wishes. Likewise, although the administrator of a donor-advised fund can deny a donor's request that a contribution be directed to a particular organization, a negotiated solution is often reached.

Another reason for the popularity of donor-advised funds is that they give high-net-worth individuals flexibility in aligning their tax planning strategy with their philanthropic goals. Donors may take a tax deduction in the year of their contribution but release the funds to various charities over a number of years. For income tax purposes, gifts to a donor-advised fund are treated the same way as gifts to public charities.

\* Throughout this chapter, we refer to gifts of securities that are made to different types of charitable organizations. Before making any gift of an appreciated security to a charitable organization, a person should speak to a tax advisor about the value of the deduction that he or she will receive. In many cases, a person is eligible to receive a fair-market-value deduction for such a gift only if he or she has held the appreciated security for more than one year.

Donors should make sure they understand the following details of a donor-advised fund before making a commitment:

- Fee structure of the fund
- Possible restrictions regarding what organizations can be supported via the fund (e.g., a community organization's donor-advised fund might not permit donations to be applied outside the community)
- Limitations on how long a family will have influence over its donated funds (influence usually does not extend beyond one or two generations)
- Administrative services the fund offers to donors (e.g., help in crafting a family's charitable-giving mission statement and policy, assistance in dealing with compliance matters related to charitable giving, etc.)

### Private foundations

A private foundation is a tax-exempt organization created exclusively for religious, charitable, scientific, literary, or educational purposes. However, the degree to which it relies on volunteers and public donations isn't sufficient to qualify the foundation as a public 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. 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 grant-making vehicles that distribute funds to other charitable organizations. Nonoperating private foundations are required to make annual distributions to qualifying charitable organizations equal to at least 5% of their assets' prior-year average fair-market value.

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. A key benefit of a private operating foundation is that gifts to it are subject to the same AGI limitations as gifts to public charities. Regardless of whether the foundation is categorized as operating or nonoperating, any gift in excess of the AGI thresholds will be subject to a five-year carryforward period (i.e., the excess amounts will be carried forward and be deductible for up to five years following the year of the gift).

A private foundation is an excellent vehicle for developing an intergenerational plan for charitable giving. Before creating a private foundation, high-net-worth families and individuals should consider the requirements related to recordkeeping, tax filing, and other administrative tasks associated with operating a private foundation. While there is no particular dollar amount required to establish this type of charitable entity, it is important to make sure there is sufficient initial funding to cover the administrative costs. These and other issues associated with creating and managing a private foundation should be discussed with your tax advisor before you settle on a course of action.

### Supporting organizations

A supporting organization is a privately organized, donor-influenced (but not donor-controlled) organization that supports a named public charity. In many respects, a supporting organization is operated in a manner similar to that of a private foundation. The major difference is that the board of a supporting organization must be linked to the public charity it supports — either through overlap in board membership or through an ongoing relationship that provides the public charity with a "significant voice" in the operations of the supporting organization.



A supporting organization is treated as a public charity for purposes of the contribution deduction rules. It does not pay an excise tax on net investment income and is not subject to the same minimum distribution requirements that apply to a nonoperating private foundation.

### **Donation methods**

Once you decide what type of charitable structure best aligns with your wealth management plan, you should solicit the help of your investment and tax advisors, as well as obtain input from any involved charitable groups. To determine whether your charitable goals are attainable and manageable, you will need to take into account your current and future wealth management plans, since no charitable strategy should be undertaken without an understanding of its impact on your current and long-term needs. Also keep in mind that once you transfer assets to a charitable organization, they are no longer within your complete control.

### **Deferred gifts**

Not all donors choose to make charitable gifts that take effect right away. Rather, some donors prefer to make charitable donations that will take effect in the future. 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 interest or a lifetime benefit. Deferred gifts to charities may take the form of annuity-type arrangements, remainder interests in certain types of property, and various types of charitable remainder trusts. These options can give donors great flexibility in meeting their charitable and wealth management goals.

### **Gift annuity**

The charitable gift annuity is among the most popular forms of deferred charitable gifts. One simple approach to this type of giving is for the donor to transfer 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 value of the property transferred and the annuity value. In addition, a portion of each annuity payment is treated as a return of capital and is not taxed as income over the person's life expectancy, as determined based on actuarial tables.

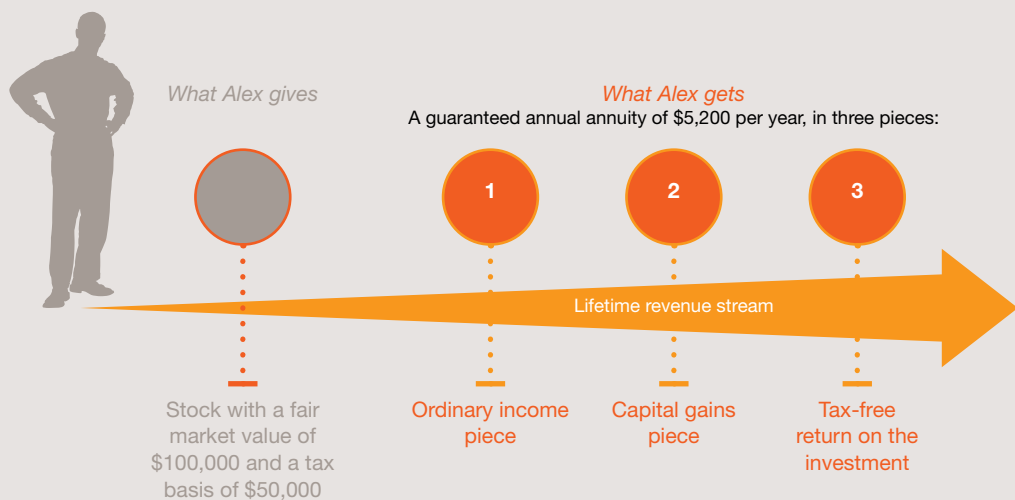
### **Remainder interest in a personal residence**

A popular method of mitigating 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. 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 individual's estate, an offsetting charitable deduction would be available for estate tax purposes.

## Gift annuity: Two birds, one stone

Benefiting others in the near term  
and yourself over the long term

Alex, who just turned 60, is contemplating early retirement. He has also been contemplating making a generous contribution to his alma mater. In assessing his financial options, he decides that rather than sell stock and pay taxes on the capital gains, he will set up a plan whereby he provides a charitable asset for his alma mater, gets an upfront charitable deduction, and has a guaranteed revenue stream for the rest of his life.



## Conservation easement

A charitable contribution deduction is also allowed in connection with the transfer of a perpetual easement in (i.e., a permanent restriction on the future use of) 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 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 area or certified historic structure.

The value of the contribution of a qualifying conservation easement is the change in the fair market value of the property after the restriction begins. Absent comparable sales of easements, fair market value is calculated by determining what the land's fair market value had been before the easement was granted and then comparing that number with the land's fair market value after the restriction is granted.

## Charitable remainder trust

The charitable remainder trust (CRT) is a popular vehicle for deferred giving, one that offers various structures to match the needs of donors. The transfer is accomplished by creating a trust that pays income to individuals during the trust's existence. After the income term expires, the property remaining in the trust goes to charity. The year the CRT is funded, the donor is entitled to a charitable deduction equal to the initial value of the remainder interest given to the charity.

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

A CRT can last for either the donor's lifetime (or the lifetimes of several income beneficiaries) or a period not exceeding 20 years. A CRT requires that the income beneficiaries be alive when the trust is created. When the noncharitable interests terminate, the remainder must pass to charity (which can include a private foundation created by the donor).

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, as determined each year based on an annual valuation of the trust assets. There is sufficient flexibility in how a CRUT may be structured such that it can include a net-income-only payout with a makeup provision. This type of structure (1) allows a donor to transfer a non-income-producing asset to the CRUT (such as real estate), (2) allows the CRUT to take time in selling the non-income-producing asset, and (3) provides for the CRUT to make up the lower, income-only payments before the sale of the asset, with larger payments after the sale proceeds have been reinvested to produce higher income.



## Charitable remainder trust

### How supporting the arts can double as a sound personal investment

Mark and Kristin own stock worth \$1 million, which they originally purchased for \$500,000. They wish to diversify their holdings yet also want to mitigate their capital gains tax. They decide that the best way to do this is to place the stock in a charitable remainder unitrust and then have the trust sell the stock.



Because the annual distribution is keyed to the fair market value of the trust each year, Mark and Kristin will either enjoy the benefits or detriments of the trust investments from year to year depending on whether the value of those investments increases or decreases.\*

The trust pays no income or capital gains tax on the sale of the stock and pays Mark and Kristin 5% of the trust's net fair market value annually during their lifetimes. Mark and Kristin name their local art museum as the remainder beneficiary. The unitrust arrangement provides them with a charitable income tax deduction of approximately \$336,000 in the year of the trust's creation. Mark and Kristin's first annual payment is roughly \$50,000.

\* A more risk-averse couple might consider structuring their remainder trust as an annuity trust instead of a charitable trust. Doing so would provide for a consistent payment from year to year regardless of investment performance.

A CRT generally does not pay income tax on investment earnings (dividends, interest, or capital gains). This permits the trust to sell appreciated property without currently paying income tax, capital gains tax, or the new 3.8% net investment income tax on the gain. Instead, the income beneficiary of the trust is responsible for income tax on the taxable portion of annuity payments received from the trust. Beginning in 2013, distributions from CRTs may also be subject to the new 3.8% net investment income tax, which will mean additional recordkeeping requirements at the trust level.

### **Charitable lead trust**

A charitable lead trust (CLT) provides a charity with income for a set period, with the remainder going to a noncharitable beneficiary (usually a member of the donor's family). In essence, a CLT is the opposite of a charitable remainder trust. Like the CRT, CLTs come in two forms: the charitable lead annuity trust and the charitable lead unitrust.

Upon creation of the CLT, the donor is allowed 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., if the CLT is a grantor trust). If the donor establishes a nongrantor CLT, the donor will not receive a charitable income tax deduction, nor will he or she be taxed on the trust's income each year. Instead, each year the CLT will be entitled to an income tax charitable deduction generally equal to the annuity paid to charity to use against the CLT's own income.

Important gift tax and estate planning objectives can be achieved through the use of a CLT. Typically the transfer of property to a family member will result in a current gift for gift tax purposes or will trigger estate taxes upon the grantor's death. However, 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 that's received by the charity.

Many of the charitable-giving strategies discussed here will benefit from the fact that the interest rates used to determine charitable deductions remain low (e.g., the lower the interest rate, the higher the charitable deduction when creating a charitable lead trust). To take advantage of these conditions, consult your tax advisor as you plan your charitable-giving strategy.

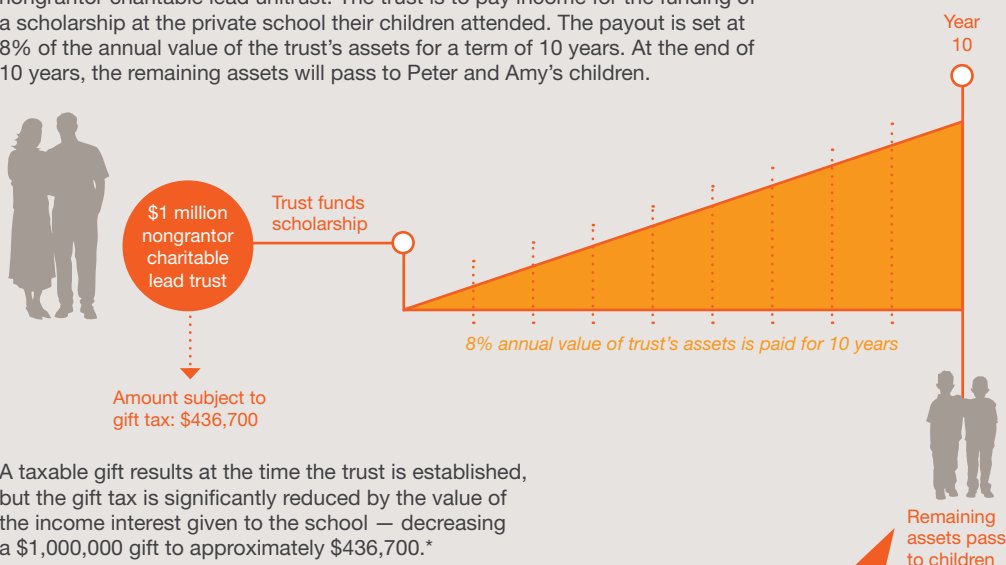
### **International charitable giving**

In today's interconnected world, charitable giving by US individuals has an increasingly global reach. While some of that reach is achieved through contributions to charities based in the United States, a good portion is also the result of contributions that US individuals make to organizations abroad. Because US income tax rules governing international charitable donations can be complex, it's important to consult a tax advisor before pursuing charitable giving across borders.

## Charitable lead trust

### Investing in future generations

Peter and Amy place appreciated securities with a value of \$1,000,000 into a nongrantor charitable lead unitrust. The trust 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 10 years, the remaining assets will pass to Peter and Amy'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 — decreasing a \$1,000,000 gift to approximately \$436,700.\*

Upon the deaths of Peter and Amy, there will be no additional estate tax, and any appreciation in the securities after their transfer to the trust will not be subject to gift or estate taxes.

Note that no income tax charitable deduction will be permitted, because Peter and Amy set up the trust as a nongrantor trust and therefore are not taxed on the trust's annual income.

Another option that had been presented to Peter and Amy was the inclusion of their grandchildren among the remainder beneficiaries of the charitable lead unitrust. Had they chosen to include their grandchildren, the transfer would have been subject to the generation-skipping transfer (GST) tax. Under that option, Peter and Amy could have considered using some of their GST tax exemption\*\* upon creating the trust.

\* This reduction is calculated by using IRS tables in the month of the contribution, at an assumed rate of 1.2 percent.

\*\* The GST exemption is \$5,250,000 for 2013.

## Charitable strategy overview: Pros and cons

### **Donor-advised fund**

#### **Advantages**

- Grants the donor a current charitable deduction for the value of the property transferred to the fund
- Subjects donations to the same AGI limits as public charities
- Generally charges low setup and annual maintenance costs
- Provides the donor with administrative support related to its charitable giving
- Requires less tax-compliance effort on the donor's part than a private foundation

#### **Disadvantages**

- Donor has no legal right to direct how donated funds are used
- Fund may limit the donor's ability to give to particular organizations
- Investment options may be limited
- Transfer of influence to successive generations may be limited

### **Private foundation**

#### **Advantages**

- Grants the donor a current charitable deduction for the value of the property transferred to the foundation
- Provides control over grant recipients
- Allows for control over investment management
- Provides for intergenerational transfer of control
- Allows donors to address an underserved need not already met by a public charity
- Excellent vehicle for developing an intergenerational plan for charitable giving, providing senior members of the family with a tool for educating the next generation in wealth management

#### **Disadvantages**

- Donor incurs additional professional fees to establish and administer the foundation
- Donations subject to tighter AGI limitations
- Annual excise tax of 1% to 2% applies to passive income, including capital gains
- Foundation subject to potential penalty provisions, IRS information-reporting requirements, and other administrative requirements

### **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 effort on the donor's part than charitable remainder or lead trusts

#### **Disadvantages**

- Donated assets pass to charity instead of heirs
- Transaction is treated partly as a charitable contribution and partly as the purchase of an annuity, meaning you cannot take a charitable deduction for the full value of property that is transferred to the charity

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### ***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 for 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 the real estate
- Exclusion of gain on sale of primary residence may be lost

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### ***Conservation easement***

#### ***Advantages***

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

#### ***Disadvantages***

- Value of and use of property is reduced for heirs

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### ***Charitable remainder trust***

#### ***Advantages***

- Grants the donor a current charitable deduction for the discounted 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

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### ***Charitable lead trust***

#### ***Advantages***

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

#### ***Disadvantages***

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

## *There are various rules impacting deductibility of international donations made by US individuals to US charities, funds, or foundations.*

Generally, contributions by an individual to a non-US charity are not deductible for US income tax purposes. That's because US tax rules specify that qualifying charitable entities must be organized under US laws. There are exceptions, however. For example, certain tax treaties between the United States and other countries allow a taxpayer to deduct charitable donations made to organizations created in specified countries. US individuals wishing to make donations to charitable organizations in countries that aren't specified in these treaties do have other options. Those options include making donations to the following organizations:

- US charities that support non-US charities (often referred to as "friends of" charities)
- US charities that operate foreign branches
- Donor-advised funds that direct distributions to foreign charities
- Domestic private foundations that direct distributions to foreign charities

There are various rules impacting deductibility of international donations made by US individuals to US charities, funds, or foundations. For example, in the case of US charities operating internationally, there are requirements regarding the level of control exerted by the US charities over their non-US charitable activities. In the cases of donor-advised funds and domestic private foundations, the organizations must (1) ensure that when donations are made to a charity abroad, the foreign entity is considered equivalent to a US charity and (2) oversee the foreign charity's usage of the funds. Individuals should consider such rules before making donations to any organization that is operating abroad.

These are just some of the issues you should bear in mind when considering international charitable donations. A qualified advisor can offer further guidance on these and other factors that affect cross-border contributions, helping you devise a charitable-giving strategy tailored to your goals.

### *Postmortem planning through charitable strategies*

Many people are familiar with the income tax benefits of charitable giving because the tax savings are realized almost immediately. However, charitable giving can also provide substantial estate tax benefits and should be considered when you develop your overall wealth management plan. Most of the charitable strategies mentioned in this chapter can also be implemented upon death, potentially resulting in a deduction when the taxable value of your estate is determined.

Unlike the income tax charitable deduction, the estate tax charitable deduction is not subject to AGI limitations, and no distinctions are made among the types of qualified donees or the types of property that are used to satisfy the charitable gift donation. Because there are complexities in implementing a postmortem charitable strategy, proper steps should be taken to ensure that the charitable deduction isn't lost.

### **Whether charitable planning makes sense for your wealth management strategy**

Many charitable-giving strategies include arrangements that require the donor to relinquish control of the donated assets. If moving your family's assets outside your control makes you uncomfortable, charitable giving might not be the best fit for your overall wealth management plan.

Using the charitable strategies discussed in this chapter can also add a layer of complexity to your wealth management plan. Many of the options discussed here entail careful planning. Therefore, if simplicity is what you're after, wealth management strategies other than charitable giving might be better suited to your situation.

### **Substantiation**

Recordkeeping and substantiation rules are imposed on donors when they make charitable contributions. The requirements vary based on (1) whether the contribution is made in cash or in property and (2) the amount of cash or the value of the property contributed.

### **Cash contributions of any amount**

A donor is not allowed any deduction for a contribution of cash unless the donor retains (1) a bank record that supports the donation or (2) a written receipt or communication from a charity showing the name of the donee organization, date of the contribution, and amount of the contribution.

### **Cash and property contributions of \$250 or more**

A donor must obtain written acknowledgment from the charity if the value of the contribution (in cash or other property) is \$250 or more. A cancelled check or other record (in lieu of a formal written acknowledgment from the charity) is not sufficient support. The acknowledgment must be contemporaneous, meaning that it must be obtained no later than the due date (or extended due date) of the tax return for the year that the contribution is made.

The written acknowledgment must explicitly state whether the donee provided any goods or services in consideration for the contribution. If the donee provided goods or services to the donor in exchange for the contribution (a *quid pro quo* contribution), the written acknowledgment must include a good-faith estimate of the value of the goods or services. If the required written acknowledgment is not properly completed and obtained in a timely manner, the charitable contribution won't be permissible.

### **Property contributions of more than \$500**

If a donor contributes property valued at more than \$500, Form 8283, *Noncash Charitable Contributions*, must be attached to the tax return for the year that the contribution is made. The taxpayer must also keep written records that include the information required for contributions valued at less than \$250.

### **Property contributions of more than \$5,000**

For contributions of property (other than publicly traded securities) valued at more than \$5,000 during the tax year, the donor must obtain a qualified written appraisal. The contribution must be accompanied by a completed Section B of Form 8283, signed by the appraiser and the donee organization.



## *Only some gifts qualify for a deduction, and the tax benefit is not automatic.*

### **Misconceptions**

As with most areas of wealth management, charitable giving has certain misconceptions associated with it. The biggest misconception may be the assumption that the financial benefit of charitable giving is solely on the side of the recipient, when in fact such giving can also create an income stream and potential tax savings for the donor (as discussed earlier).

Another frequent misconception is that all gifts qualify for a charitable income tax deduction. They do not. Only some gifts qualify for a deduction, and the tax benefit is not automatic. To receive the tax benefit, the donor must include the gift as an itemized deduction on his or her individual income tax return (or a return filed jointly with a spouse/partner). Contributions that are not deductible include those made to individuals, as well as those made to the following entities:

- Political parties
- Organizations that engage primarily in lobbying activities
- Political action committees
- Social and sports clubs
- Chambers of commerce
- Trade associations
- Labor unions
- Certain social welfare organizations
- Most foreign charities
- Other nonqualified organizations

Likewise, the following payments are among those that do not qualify as charitable contributions: tuition; dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups; and purchases of raffle tickets. The same holds true for the value of a volunteer's time or services. In some cases, a portion of the ticket or admission price that charitable organizations charge for fundraising events (e.g., dinners, golf tournaments) may be deducted by attendees. In other instances, however, those costs might not be deductible, so be careful that you don't automatically assume otherwise (the substantiation requirements specify that charities must disclose to their donors the deductible and nondeductible portions of any tickets or admission charges).

Taxpayers should also be careful to obtain and retain contemporaneous documentation of any charitable donations made to an organization.

Other common misconceptions about charitable giving pertain to which types of assets are best suited to certain wealth management goals. An experienced advisor can help dispel confusion and recommend charitable-giving options that are compatible with your objectives.

## **Conclusion**

Ideally, charitable-giving strategies and wealth transfer objectives are created in tandem. In that way, they complement each other in an overall wealth management plan while benefitting society in the process. Many individuals have found that the latter accomplishment is among the most rewarding aspects of managing their family's wealth.

A photograph of a family of five on a sandy beach. In the foreground, a young woman with blonde hair tied back, wearing a red turtleneck, smiles and looks towards a man. The man, wearing a green turtleneck, is also smiling and looking at her. Behind them, a young boy in a red sweater is leaning over the man's shoulder, smiling at the camera. In the background, an older couple is sitting on the sand, looking out towards the ocean. The man is wearing a red sweater and the woman is wearing a white turtleneck. The sky is overcast and the ocean is visible in the distance.

# *Estate and gift planning*



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**Ch4** Estate and gift planning, done right, evolves over time to reflect your changing goals and circumstances.

Thoughtful estate and gift planning helps you preserve your wealth and pass it on to your designated beneficiaries in the manner you choose. Done haphazardly, however, such planning can result in your family and other beneficiaries receiving less than you intended. It's important, therefore, to be aware of the various estate and gift planning options and make an educated assessment of which ones are best for you and your family.

There are many potential objectives, both financial and nonfinancial, to consider in the estate planning process. Those objectives — and the relative weight you place on them — are likely to change over time. For that reason, you will want to review your estate plan periodically to ensure that it evolves as your goals and circumstances do.

***Estate and gift tax rules for 2013 transfers***

Tax implications are an important consideration in the development of any estate plan. The gift and estate taxes have undergone numerous changes over the years, including rule changes established under the American Taxpayer Relief Act of 2012 (ATRA).

Signed into law on January 2, 2013, ATRA reunified the estate, gift, and generation-skipping transfer (GST) tax exemption amounts. It also established the estate and gift tax exemption as \$5 million (\$5,250,000 for 2013 as indexed for inflation), increased the top estate and gift tax rate from 35% to 40%, and made portability permanent.

The table at the top of the next page illustrates the estate and gift tax rates and exemptions that are in effect for 2013.\*

Individuals can now transfer \$5,250,000 (a combined \$10,500,000 for a married couple) free of estate, gift, and GST tax during their lifetime or upon death. Since 2012, this is an increase of \$130,000 (\$260,000 for married couples).

### **Portability**

Portability allows the surviving spouse to use the deceased spouse's unused lifetime gift and estate tax exemption amount during the surviving spouse's lifetime or have the amount be applied upon death. Therefore, if one spouse dies with an estate tax exemption amount remaining, the surviving spouse's remaining exemption will be increased by the deceased spouse's unused amount. Portability gives individuals another opportunity to maximize the use of both spouses' exemption amounts, especially if a lifetime plan has not been put in place or fully implemented. Portability does not apply to the GST tax exemption.

### **When is an estate plan appropriate?**

Although the complexity of an estate plan can vary widely depending on a person's individual circumstances, objectives, and family situation, you should have some form of estate plan if the following holds true:

- 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, to delay or stagger the beneficiaries' receipt of the property, or to allow multiple beneficiaries or generations to benefit from the same assets.
- You have, or anticipate eventually having, an estate large enough to require the payment of estate taxes upon your death.
- You have minor children.
- You are a business owner.
- You want to protect your assets from potential claims by your creditors and beneficiaries (as well as protect your beneficiaries from potential creditor claims).
- You own property in more than one jurisdiction.
- You or your spouse is not a US citizen.
- You are in a nontraditional relationship, or your immediate relatives are not your intended beneficiaries.
- You want to designate who will manage your property if you become disabled or ill in the future.

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\* Twenty-one states and the District of Columbia have some form of state and inheritance tax. You and your advisors should check to see whether there are differences between the federal estate and gift tax laws and your state's tax laws.

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### Estate and gift tax rates and exemptions for 2013

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Highest estate/gift tax rate	40%
Estate tax exemption	\$5,250,000
Gift tax exemption	\$5,250,000
GST exemption	\$5,250,000
Gift tax annual exclusion	\$14,000

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Lack of an estate plan could result in the following unintended consequences:

- Inheritance of your property by people you did not wish to be your beneficiaries or in a manner not of your choosing — e.g., your children inherit all or a portion of your estate, when in fact you intended to leave everything to your surviving spouse, or vice versa
- An incorrect form of property transfer — e.g., property transferred directly to a person who is uninterested in or incapable of handling property or, conversely, property placed in a trust when in fact circumstances warrant giving the property directly to the beneficiary
- Improper ownership of assets (separate ownership by husband or wife, or some form of joint ownership), which can jeopardize full use of tax exemptions or cause property to pass in a way that is contrary to your intentions
- Higher combined estate and gift taxes because of failure to take full advantage of available estate and gift tax exemptions, exclusions, deductions, and credits
- Adverse impact on a family-owned business due to lack of an ownership or management succession plan
- Lengthy and emotionally painful court proceedings concerning the appointment of guardians for your children
- Court appointment of a representative to make financial or healthcare decisions for you in the event of your incapacity
- Higher-than-necessary nontax administration expenses and transfer costs
- Estate administration becoming public
- Lack of liquidity and the forced sale of estate assets to pay expenses and taxes

Because a person's circumstances and priorities are likely to change over time, the considerations that go into determining whether to have an estate plan (or to modify a current one) are apt to change as well. Periodically contemplating the factors noted here is therefore a good idea.

### **Estate planning: Four main steps**

Although each person's situation is unique, most people are best served if they follow a four-step process in their estate planning:

- Assess the current situation
- Determine planning options
- Implement the estate plan
- Monitor the plan

### **Step 1: Assess the current situation**

The first step in any plan is to review your personal and financial situation. Once you've done that, determine your goals with respect to your wealth preservation and legacy. With those in mind, you should then analyze any current wills, trusts, and other wealth management documents.

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

- Listing the types and locations of your assets, as well as the current value and tax basis of each asset
- Determining the current ownership of each asset — that is, whether the property is owned by you, by your spouse/partner, or jointly (and the type of joint ownership) or whether it is community property; the form of ownership can dictate who receives the property upon death, so this determination is a critical part of the estate planning process



- Reviewing the beneficiary designations for certain assets (life insurance policies, retirement plans, deferred compensation, etc.)
- Evaluating the appreciation potential for various assets\*

In this chapter, we've already noted a number of common reasons for having an estate plan. Other key objectives tend to include the following:

- 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 healthcare decisions in the event that you or your spouse becomes incapacitated
- Maintaining control over your assets during your lifetime
- Ensuring that your property is distributed according to your wishes — e.g., specifying who receives your property, the amount the recipient receives, the form in which he or she receives it (outright or held in trust), and who will manage your property for your heirs
- Making sure your property is transferred in an efficient, quick, and orderly manner
- Reducing the overall estate and gift tax liabilities — e.g., reducing the 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 your business and planning for ownership and management succession

It's essential to determine how important each of these objectives is to you. Once you have done so, you may find it helpful to create an estate flowchart that illustrates how your estate will pass to the beneficiaries designated in your current documents. The flowchart can incorporate the estimated estate tax due, if any, and a liquidity analysis to determine how the tax and other expenses will be paid. It is a good idea to make the plan sufficiently flexible so that it remains applicable if various circumstances change.

## Step 2: Determine planning options

Using the information gleaned from the assessment stage, you can begin to determine which estate planning techniques are best suited to you and your family. The first few techniques discussed in this section make sense for just about anyone. They're followed by more-advanced estate planning ideas.

### Draw up a will

If you do not have a will, the law of your state of residence will generally determine who receives your property upon your death and how and when the designated individuals receive the property. In many states, if you are married with children, lack of a will means that your surviving spouse will not receive all of your assets; instead, a portion will pass to your children. In addition, you may miss the opportunity to generate significant estate tax savings for your family. Even if an estate is not large enough to require the payment of estate tax, a will is nonetheless worth having, since it can be used to name guardians for minor children and specify who will receive assets and when.

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\* A major benefit of making lifetime gifts is that any appreciation in the property that is given away will not be subject to estate and gift taxes. Therefore, identifying the appreciation potential of each asset is important.



## *Lack of a will means that you may miss the opportunity to generate significant estate tax savings for your family.*

### **Sign “durable power of attorney” and healthcare proxy forms**

It’s also useful to complete a “durable power of attorney” form and a healthcare proxy form. These documents specify who can make financial and healthcare decisions for you in the event that you become incapacitated. They, along with a will, are especially important to have if you are in a nontraditional relationship (i.e., a relationship not necessarily recognized by law) or do not want your immediate relatives to be your beneficiaries or to make decisions on your behalf.

### **Designate an executor and trustee**

Your executor will be in charge of administering your estate. The trustees will be in charge of administering any trusts created during your lifetime or through your will. An important part of the estate planning process, therefore, is the selection of the individuals who will fill those roles (and their alternates, in the event that the selected individuals are unable or unwilling to serve). This involves weighing the advantages and disadvantages of assigning these roles to family members instead of to a professional advisor such as an attorney, a professional trustee, or some combination thereof.

### **Review property ownership and beneficiary designations**

For couples, part of the estate planning process involves evaluating whether you and your spouse (or partner) each have enough property in your separate names to take full advantage of the estate, gift, and generation-skipping transfer tax exemptions, exclusions, and credits that are in effect at any particular time. A review of asset ownership can help you determine whether lifetime gifts or transfers between you and your spouse or partner should occur to ensure that you each have enough assets in your own names to take full advantage of your available tax exemptions. As discussed earlier in this chapter, portability may allow you to take full advantage of both spouses’ exemptions. Failure to plan properly in this vein can significantly increase your overall tax liability.

Bear in mind, however, that if you want some of your property and assets to go to individuals other than your spouse or partner upon your death, and you and your spouse or partner agree to joint ownership with rights of survivorship, you may end up defeating an otherwise excellent estate plan. That is because right of survivorship means that your spouse or partner will automatically receive the jointly owned property and assets upon your death, with none of those assets going to your children or other potential beneficiaries. Owning property and assets in this manner might also curb the ability to take advantage of the full estate tax exemption amounts allowed for both an individual and his or her spouse.

## *Spouses are each entitled to an estate tax exemption of \$5.25 million for 2013.*

Another consideration to keep in mind is that if you live (or used to live) in a community property state\* and are married, most assets and property acquired while you were living in that state as a married person are generally treated as half-owned by each spouse, regardless of whose name the assets are in. This can cause issues similar to those that may arise as a result of joint ownership with rights of survivorship (i.e., with regard to passing the property to children or other beneficiaries or taking advantage of the full estate tax exemption amounts allowed for both you and your spouse).

Realize, also, that the recipients of several types of assets, such as deferred compensation and payouts from life insurance policies and retirement plans, are not specified by your will. Rather, they are determined by beneficiary designations that you arrange through the plan providers. It is important to review the beneficiary designations periodically, as well as the alternate beneficiary designations, for all of these assets. Failure to do so can result in adverse consequences, such as the wrong person receiving the asset, less flexibility in your estate plan, increased income tax liability, and increased estate tax liability due to failure to use exemption amounts or take full 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, so long as the receiving spouse is a US citizen.

Wills should address how property is to pass to the surviving spouse. Generally, to qualify for the marital deduction, property must pass to the surviving spouse in one of three basic ways: (1) outright, (2) via a “general power of appointment” trust, or (3) via a “qualified terminable interest property” trust.\*\*

An important part of estate planning involves determining which of these three options is best suited to meet your goals. Recognize that these options are not mutually exclusive; the total property passing to the surviving spouse may be divided, with different methods potentially 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 property’s ultimate disposition and financial management. If the marital transfer is made by outright bequest, the spouse who dies first will have no control over the ultimate disposition of the property. This concern may be particularly

\* Nine states have community property systems: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Washington, and Wisconsin. (Alaska’s community property system is elective; both spouses must opt in.)

\*\* There is a fourth option — an “estate” trust, which requires that the remainder interest in the property be left to the estate of the now-deceased surviving spouse. However, this option has rarely been used since the introduction of the qualified terminable interest property trust rules, and so it is not discussed in this guide.

relevant if either spouse has children from a previous marriage or if the surviving spouse remarries. Additionally, the surviving spouse may lack experience — or have little interest — in the financial management of property. Discussing this potential responsibility with your spouse before making a decision is therefore advisable.

One way to address concerns about the financial management of property while also ensuring that a transfer to a spouse qualifies for the marital deduction, is to use a trust for the transfer. One such trust is a “general power of appointment” trust. It stipulates a mandatory annual distribution of income to the surviving spouse, allows for discretionary distributions of principal to that individual, and lets him or her decide who receives the property when he or she dies. The drawback to this arrangement is that it doesn’t give the first-to-die spouse control over the ultimate disposition of the property. It is important to consult the estate tax rules in the state where you reside. In some states, the “general power of appointment” trust is the only type that qualifies for the marital deduction.

A transfer also qualifies for the marital deduction for federal purposes if the property is transferred to a “qualified terminable interest property” trust. This type of trust stipulates mandatory annual distribution of income to the surviving spouse, allows for discretionary distributions of principal to that individual, and lets the first-to-die spouse decide who will receive the remaining property upon the death of the surviving spouse. This arrangement may alleviate concern about both the financial management and the ultimate disposition of the property. However, this technique also makes the plan considerably less adaptable to changes in circumstances occurring between the deaths of the spouses.

Note that if the surviving spouse is not a US citizen, a trust will qualify for the unlimited marital deduction only if the property passes through a qualified domestic trust (QDOT). A QDOT has special rules and requirements that need to be referenced in the trust document, as well as strictly followed each year in order to maintain the marital deduction.

### Use the estate tax exemption

Spouses are each entitled to an estate tax exemption of \$5,250,000 for 2013, which can be used after their deaths to protect that amount from estate tax. If a decedent leaves all property to his or her spouse, there will be no estate tax (due to the marital deduction). The surviving spouse may be allowed to use any unused estate tax exemption. When the surviving spouse dies and the combined property then passes to other beneficiaries, the unused estate tax exemption of the first spouse will be portable, meaning that it can be added to the second spouse’s exemption to offset the estate tax.

No state that collects a separate state estate tax has yet instituted portability of the state estate tax exemption between spouses. Also, as previously stated, the generation-skipping transfer tax exemption is not portable between spouses under current law.

There are, however, various other ways to use the estate and gift tax exemption to significantly reduce the 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, to name several methods.

## *You can give individual gifts of up to \$14,000 to any number of people annually without having to pay a gift tax.*

### **Give lifetime gifts**

Over time, an annual giving program can remove hundreds of thousands of dollars from your estate on a tax-free basis. You can give individual gifts of up to \$14,000 (\$28,000 if you're married and your spouse joins in the gift) to any number of people annually without having to pay a gift tax.

These "annual exclusion" gifts remove property from your estate without resulting in a gift or estate tax cost and can shift income-earning property to family members in lower income tax brackets. This also eliminates from your estate any future appreciation in the value of the transferred property.

If the people to whom you would like to make gifts are minors, and you do not want to make outright transfers, you can avail yourself of several alternative account and trust arrangements that will qualify your gift for the annual exclusion without requiring you to make outright transfers.

In addition to the \$14,000 annual exclusion, there is an unlimited gift and GST tax exclusion for any tuition paid directly to a school or for medical care payments made directly to a healthcare provider on someone else's behalf. Not only are these tuition and medical payments free of gift tax, but they also 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 generally qualify for this exclusion.

Gifts to a qualified tuition program, or 529 plan, do not qualify for the unlimited tuition gift tax break. However, there is a special rule allowing a contribution that is made to such a program or plan in a single year to be spread over five years. If done properly, this technique enables you to use five years of annual gift tax exclusions for a gift made in one year. For example, in 2013, an individual could transfer up to \$70,000 to a 529 plan and elect to treat the contribution as having been made ratably over five years.

In 2013 there is also a \$5,250,000 gift tax exemption; the first \$5,250,000 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 upon death. However, even though the exemption may continue to be available upon death, you may nonetheless want to make gifts up to the \$5,250,000 exemption in your lifetime to eliminate future appreciation from your estate. Not doing so could translate into a lost opportunity if the law should change.

## *Give now, in 2013, to save down the line*

Karen, a widow in her sixties, has a securities account worth \$5 million. Her investment advisor tells her that the account is likely to grow by \$3 million, reaching a total of \$8 million in her lifetime.

\$5 million

After also consulting with her accountant and estate attorney, Karen decides to give the \$5 million to her three children. Doing so allows use of the lifetime gift tax exemption now instead of upon Karen's death.

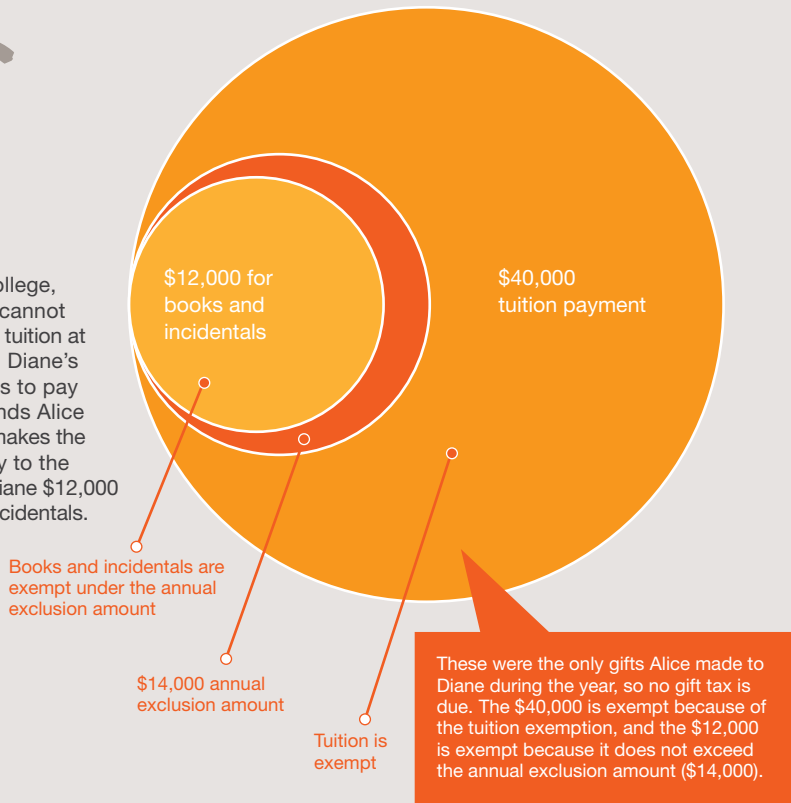
If Karen had instead decided to bequeath the money through her will, she would have run the risk of her family ultimately paying tax on any value above the exemption, as well as tax on the appreciation of the \$3 million.

Karen consequently eliminates about \$3 million of future appreciation from her estate.

## *A nontaxing way to play fairy godmother: Paying for college*



Diane wants to attend college, but she and her parents cannot afford the \$40,000 annual tuition at the school of her choice. Diane's grandmother, Alice, offers to pay Diane's tuition. Diane sends Alice the tuition bill, and Alice makes the \$40,000 payment directly to the school. Alice also gives Diane \$12,000 to cover her books and incidentals.



### Consider trusts and family entities

Earlier in this chapter, we discussed using trusts to transfer property to a surviving spouse. We will now look at several other types of trusts that can be used to pass on wealth.

#### *Life insurance trust*

When the proceeds from a life insurance policy that you own are paid to your beneficiaries, those proceeds are included in your gross estate and are therefore subject to estate tax. One way to protect those proceeds from estate tax is to transfer the life insurance policy 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.

Note that a life insurance policy that is transferred into an irrevocable trust will not be officially removed from your estate until three years after the date of transfer. For a new policy, 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, rather than three years later.

#### *Grantor retained annuity trust*

To transfer the future appreciation of an asset to beneficiaries without giving up the current value of the asset (plus a fixed annual interest payment), consider transferring the asset to a grantor retained annuity trust (GRAT).

A GRAT allows you to retain the right to receive for a specified term of years an annuity stream 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 IRS) for the month the GRAT is created. If the trust assets produce an actual economic rate of return that exceeds the fixed return, the GRAT's beneficiaries will receive the excess either in trust or outright, and at little or no gift tax cost. While the assets are in the trust, you will remain responsible for the income tax liability on the income earned by the trust. The payment of the income tax liability provides an income tax benefit for the beneficiaries of the trust, since the tax payments are not considered gifts to the trust or the beneficiaries.

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 free of gift tax. Typical assets placed in this type of trust include interests in closely held businesses, certain publicly traded stock, and other assets that are expected to grow quickly in value.

GRATs also work best when interest rates are low, because appreciation in the 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.

Selecting an appropriate term for the GRAT is very important, since you must survive the term of the trust in order for the assets to be removed from your estate.



## GRAT gratification

How one business owner achieves substantial estate tax savings



Business owner Dan Traver creates a two-year grantor retained annuity trust (GRAT), transferring to it three million shares of Traver, Inc. stock, valued at \$1.50 per share (total value **\$4,500,000**).

Put in:  
**\$4,500,000**

*Over the two-year life of the trust, Dan must take annuity payments that add up to the original value contributed (\$4.5 million) plus a return based on an interest rate determined by the IRS.\**

Year 1

Year 2

Take out:  
**\$21,963,000**

At the end of Year 2, the shares of Traver, Inc. appreciate to \$10 per share. Dan has effectively transferred about \$21,963,000 out of his estate. At the top estate tax rate of 40%, he achieves a tax savings of roughly **\$8,800,000**.



If Traver, Inc. stock were to decline in value or stay the same during the GRAT's term, all of the stock would be returned to Dan in payment of the annuity and remain in his estate (worst-case scenario).

\* For purposes of this example, we are using an assumed interest rate of 1.2 percent.

Although no changes to the GRAT rules have yet been made, Congress has been discussing new legislation that would make GRATs less beneficial. If passed, the proposed new legislation would, among other things, require a 10-year minimum term for GRATs and a remainder interest greater than zero, effectively eliminating the “zeroed out” GRAT. For this reason, and because interest rates are currently at low levels, it may be wise to consider establishing a GRAT sooner rather than later.

#### *Qualified personal residence trust*

A personal residence — either a principal residence or a 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 the 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. After the term interest in the trust ends, the grantor may arrange 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. 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, since the remaining value after your retained term is the measure of the gift.

#### *Intentionally defective irrevocable trust*

A sale to an intentionally defective irrevocable trust (IDIT) is a technique that may allow you to transfer the future appreciation in an asset to beneficiaries while keeping the current value of the asset, plus a fixed annual interest payment. An IDIT is considered the same as the grantor for income tax purposes. Typically, there are two basic types of IDIT transactions: gifts and sales. For the gift transaction, the way the trust is drafted would cause any gifts to the trust to be treated as completed gifts (i.e., “true” gifts) for estate and gift tax purposes but not for income tax purposes.

Alternatively, a sale transaction can also be used to reduce the gift tax that might otherwise be due on a simple gift transaction.

After setting up an IDIT, you would sell an asset to the trust in exchange for the trust’s promissory note. The terms of the promissory note would require the trust to pay you an amount equal to the fair market value of the property at the time you sold the asset to the trust, plus a fixed rate of interest. The interest rate would be based on the prevailing interest rate (as published by the IRS) for the month the sale occurs and would also depend on the length of the note and the frequency that interest payments must be made (annually, semiannually, quarterly, etc.). IDITs work best when interest rates are low, because appreciation in the assets above the interest rate on the note passes to the beneficiaries.

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 trust or outright, at little or no gift tax cost. Unlike GRATs, IDITs can also be used effectively as a tax planning tool vis-à-vis the generation-skipping transfer tax.

## *Family partnerships enable family members to invest through a single vehicle, which can reduce investment costs.*

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 pass to the IDIT beneficiaries free of gift tax. Typical assets placed in this type of trust include closely held businesses, publicly traded stock, and other assets that are expected to grow quickly.

Realize that 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 — hence, the trust is “defective.” The reason that an IDIT is nonetheless an appealing option is that the income tax payment provides an income tax benefit for the trust beneficiaries. The tax benefit stems from the fact that what the beneficiaries receive from the trust will not be diminished by the income taxes owed by the trust, yet payment of the income tax by the person who set up the trust is not considered a gift to the trust or to the beneficiaries.

As with GRATs, there have been congressional proposals to change the tax results of an IDIT, meaning that if you’re contemplating setting up an IDIT, it may be a good idea to do so sooner rather than later.

### *Dynasty trust*

A dynasty trust is generally created as part of a plan to mitigate the impact of the generation-skipping transfer (GST) tax. This is an additional tax applied against the value of property that’s transferred to people who are defined as “skip persons.” A skip person is someone who is considered two or more generations younger than the person who is making the transfer. The GST tax is in addition to potential estate or gift taxes on the same transfer. It is designed to ensure that a tax

is collected on the transfer of wealth from one generation to the next. As noted earlier, the GST tax exemption for 2013 is \$5,250,000. A dynasty trust helps you take full advantage of your GST tax exemption and is typically set up to last for as long as is allowed by the state law governing the trust.

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

### *Charitable trust*

Charitable trusts can help you to achieve your charitable objectives and obtain a charitable deduction while (1) still retaining an interest in your property or (2) giving an interest in the same property to other beneficiaries, such as children.

In a charitable remainder trust you would transfer assets to the trust and either keep or give to others the right to receive an annual annuity or unitrust payment for a specified number of years (or for life). At the end of the term (the specified years or upon death), the remaining assets pass to charity.

A charitable lead trust essentially works in reverse: The charity is entitled to receive an annuity or unitrust payment for a specified number of years; at the end of the term, the remaining assets are returned to you or given to the beneficiaries of your choosing. For more details, please refer to this guide’s chapter on charitable giving.

### *Family limited partnerships*

A family partnership is an excellent way to control and grow wealth. The family partnership is a separate business entity that can hold title to assets, collect income and gains, pay expenses, and file tax returns. A family partnership often takes the form of a limited liability company (LLC), which is treated as a partnership for tax purposes, or a limited partnership (often referred to as a family limited partnership or FLP).

One popular reason for forming a family partnership is to facilitate the transfer of wealth. That's 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. Generally, property is contributed to a family partnership in exchange for both general and limited partnership units.

As a rule, the retained value of general partnership interest will be small, because the objective is to transfer the bulk of the value (through the limited partnership units) to younger generations. If the partnership is properly structured and administered, gifts of partnership or LLC units will not be included in the donor's estate once those gifts have been made.

Additionally, substantial discounts are often allowed in valuing the limited partnership units that are transferred — for instance, if the limited partnership units aren't marketable (marketability discount) or if the limited partners don't control the partnership (minority interest discount).

There is also 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. In addition, family partnerships offer protection of assets from creditors. Finally, family partnerships enable family members to invest through a single vehicle, which can reduce investment costs, facilitate recordkeeping, and provide flexibility that might not be available in a trust arrangement.

Because family partnerships are often involved in sophisticated estate planning arrangements, they are routinely scrutinized by the IRS. When the IRS is involved, the most controversial issue is typically the question of whether the value of a partnership unit should be discounted for gift or estate tax purposes; if the IRS invalidates the partnership, the discount related to the partnership is removed, and occasionally the entire gift is invalidated.

The IRS tends to concentrate on partnerships that are not operated in a proper business manner or ones in which family members need constant distributions for living expenses. Properly structured and operated, however, an FLP can be a very useful tool.

## Cross-border considerations



### Transfer tax treaties

The United States is party to several treaties designed to mitigate exposure to double taxation that would otherwise result when both the United States and another country impose a wealth transfer tax on the same property.

It is important that you consider the potential impact of these treaties when assessing your estate plan if (1) you or your spouse is/was treated as a tax resident of another country, (2) you own property in another country, or (3) you are considering gifts or bequests to residents of other countries.

By keeping transfer tax treaties in mind while you do your estate planning, you may be able to reduce your overall exposure to US and foreign wealth transfer tax — for example, by managing what's considered your main residence or by changing the ownership structure or deemed location of your property and assets.

### Foreign-based property

If you own foreign-based property, such as a villa or apartment, take care that you consider which ownership and disposition arrangements will result in the greatest global tax efficiency and reduce adverse consequences upon sale, gift, or bequest.

In these situations, it is important to review foreign jurisdictions' requirements for wills and other testamentary documents, as well as their rules regarding forced heirship and rights of survivors. Another key concern is how your property would be managed if you were to become disabled.

You might also want to consider whether to use (1) a single will to dispose of all property worldwide or (2) separate wills governing the transfer of property in each jurisdiction where major assets are located, along with a will for the disposition of your remaining assets.

As in the United States, adverse outcomes can sometimes be avoided or mitigated in foreign jurisdictions by using trusts and entities such

as corporations and partnerships as substitutes for direct ownership of property. However, because the laws of foreign countries differ as to what types of entities are recognized and how they will be treated for tax and other purposes, it is important to ensure that your planning is globally coordinated.

### Matrimonial property

Many foreign countries, particularly in Europe and Latin America, employ community property or quasi-community property systems. Married couples that own property in such countries will want to bear in mind how property succession considerations may impact their estate plan. They should also carefully evaluate US and foreign tax considerations before transferring property that they own in those jurisdictions.

### US wealth transfer taxes — applicability to noncitizens

Even if you (or a relative) are not a US citizen or not considered a resident of the United States, it is important to determine whether you might be subject to US estate and gift tax. For example, you could be subject to such tax by reason of the ownership of property (e.g., real estate) or assets that are considered situated in the United States for purposes of these rules.

You should also be aware that for purposes of the estate and gift tax, residency is tested differently from how it is tested for income tax purposes. While income tax residency is determined through objective tests (such as measuring the number of days the person spent in the United States), estate and gift tax residency is measured subjectively on the basis of intent.

As a result, if you have noncitizen status in the United States, you may nonetheless be treated as a US resident for purposes of estate and gift tax, even if you are not treated as a resident for income tax purposes.

It is also important to note that there can be significant differences between the application of the US estate tax and the US gift tax, including the determination of what is taxable and your eligibility for exclusions, deductions, and exemptions from tax.

### Step 3: Implement the estate plan

Once the different estate and gift planning alternatives have been evaluated, the next step is implementation. Finding a qualified attorney who has estate and gift planning experience relevant to your needs can be crucial to the success of your estate plan. The estate and trust attorney should prepare documents for your review to ensure their accuracy. Most importantly, the attorney must ensure that the documents are properly executed in accordance with state law requirements.

Implementation also involves producing an estate tax balance sheet that reflects the changes made and then revising the estate flowchart to illustrate how the estate will pass according to the new plan.\* The flowchart would, as described earlier in this chapter, 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, you may find it necessary to alter your plan to reflect changes in the following:

- Your objectives or their relative importance to you
- The composition of your family (birth, marriage, divorce, death)
- Your beneficiaries' personal situations
- Your financial situation
- Tax law
- Your state of residence

When such changes occur, it is appropriate to either modify your estate plan or create a new one.

It is also important to routinely evaluate your estate plan in light of the current tax law. By working with your advisors, you can ensure that your income tax planning is coordinated with your estate planning.

### Conclusion

Though careful estate planning can be a complex undertaking, it delivers clear rewards — peace of mind for you now and security for your family down the line. By establishing a well-considered and comprehensive plan today, and updating it as needed, you'll help ensure that your wealth and your vision for it survive far into the future.

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\* For couples, two flowcharts should be drafted — one showing how the estate would pass if you were to die before your spouse or partner, and the second flowchart showing vice versa.



A photograph of a middle-aged man with grey hair, wearing a dark blue suit, a striped shirt, and a red tie. He is seated at a wooden table, gesturing with his hands as if in conversation. To his left, the back of another person's head and shoulder are visible. In the background, there is a large round clock on the wall and a lamp with a patterned shade. The overall setting appears to be a professional or business environment.

# *Business succession*





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**Ch5** Sound planning is critical to the successful transfer of a business.

Family businesses tend to be closely held, with the presiding family having the greatest investment in and control over the enterprise. However, there can be many other interested parties as well, including customers, suppliers, and employees, to name just a few. To those parties, it matters who will own and run the business in the future. Lack of information about this can signal uncertainty in an already uncertain economy, with potentially adverse effects on both the near-term health and longevity of the company. A clearly communicated succession plan, on the other hand, can help assure stakeholders that the business is here to stay.

**Passing the baton... with due foresight**

Often, the controlling or majority owner is as emotionally invested in the business as he or she is financially invested. In such cases, the owner tends to maintain voting control, usually for his or her lifetime. This factor, along with the desire to keep all aspects of the business confidential, generally means that the majority owner is integrally involved in the operations of the business — sometimes to the exclusion of more hands-on involvement by other family members, who would benefit from a better understanding of how the business is run.

The day will come, however, when the controlling owner must — whether because of illness, death, or other circumstances — relinquish his or her ownership interests to another party. Unfortunately, many business owners choose to ignore this inevitability. As a result, they don't develop a business succession plan.\*

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\* Thirty-eight percent of US family businesses say that succession planning will pose a substantial challenge in five years' time, suggesting that planning has not yet begun. (*Playing Their Hand: US Family Businesses Make Their Bid for the Future*, PwC, 2013.)

Lack of a formal succession plan can lead to a number of problems when the current owner ceases to maintain control. For instance, subsequent generations may be reluctant, unprepared, or unable to take the reins. Then again, the owner might identify a willing successor but find that family members and other key stakeholders do not support the decision. The business owner could also discover that keeping things in the family simply isn't feasible (e.g., there isn't enough liquidity to support a family buyout from the generation that currently owns the business). Although such issues can be difficult to confront — and therefore tempting to put off — it is better to deal with them now rather than at the last minute, when options may be limited.

### ***Paving the path forward: Main steps***

There are certain basic but critical steps that should be taken to help ensure the successful transfer of a business. Too often, however, such steps are skipped or else not taken soon enough. Yet it is important to have a sense of urgency, because someone will need to take the reins if the business owner unexpectedly becomes unable to lead the company. Early planning should help a family's succession strategy be flexible enough to alter course as circumstances change.

Perhaps most critically, early planning can help a business owner determine whether passing the business on to the next generation is in fact feasible. If it turns out that the answer is no, the owner will need to have a well-considered Plan B (e.g., sale to other shareholders or a third party). If, however, keeping the business in the family is a realizable goal, the owner will improve the odds of fulfilling that goal by taking the following steps.

### **Establish business policies for family members**

Before identifying a successor, the current leader should establish general policies regarding the employment of family members. Such policies help the leader consider whether it is in the best interests of the business and the family for particular family members to be employed by the business. Certainly there will be cases in which some family members will be deemed fit to run the business and others won't.

If only some family members are involved in running the business, the owner may struggle to be fair to all. It serves the long-term interests of both the business and the family to acknowledge family members who make the greatest contributions to the company. This can be done by establishing a compensation policy that is commensurate with the fair value of their services.

Nonparticipating family members, meanwhile, can be given equity interests in the business. The business can then make periodic dividend distributions in an effort to make all family members feel equal.

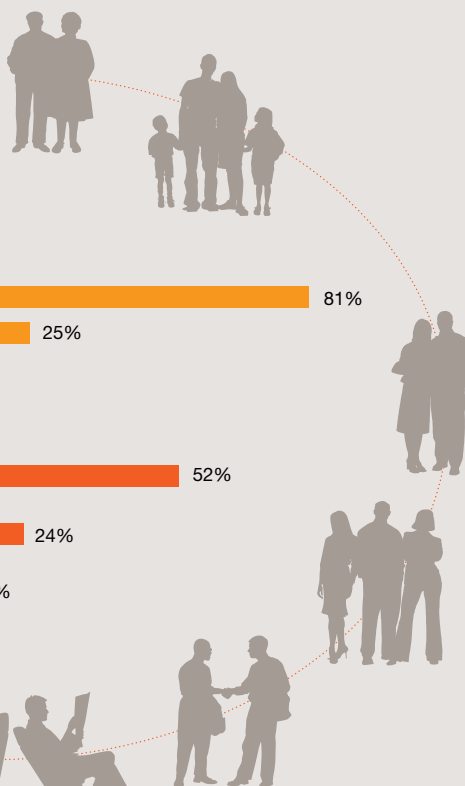
For businesses that are organized for tax purposes as flow-through entities, the equity owners will be responsible for paying taxes on the income of the business. Without distributions from the business, there may be family members who cannot afford to pay their portion of the business's tax liability. In these cases, the business should establish a distribution policy to ensure that the owners are treated fairly.

## Lifecycle of a family business

### Take time to map it out

A successful transition almost always hinges on a well-considered, written plan that clearly specifies the disposition of ownership interests in the business.

The earlier the owner develops the plan, the better. That's because the more time there is to prepare for succession, the greater the opportunity to maximize the business's value and reduce the risks involved when an owner or key employee exits the business.



#### US family business snapshot\*

Family-run for two or more generations	81%
Ownership change anticipated within approximately five years	25%

#### Contemplated form of ownership change

Pass the business on to the next generation to own and run	52%
Pass the business on to the next generation to own but not run	24%
Sell to another company	12%
Sell to a private equity investor	4%

\* Source: *Playing Their Hand: US Family Businesses Make Their Bid for the Future*, PwC, 2013 (multiple responses allowed)

Q13: How many family generations have managed the company?

Q16: Do you anticipate any change in the ownership of your business over the next five years or so?

Q17a: What sort of changes do you anticipate in the next five years or so?

Percentages reflect responses from US participants in the survey.

## Identify a successor

To provide certainty that the business will survive beyond its current ownership, the individual(s) at the helm must choose a successor. The successor can be another family member, shareholder, key employee, or an outside party, such as an executive from another business. This last option might make sense if family members are not interested in leading the company or lack the right qualifications. Sometimes an outside executive may serve an interim role, functioning as a bridge until younger family members are ready to take on senior management roles.

Choosing a successor and communicating that choice sooner rather than later not only demonstrates a commitment to keeping the business going, but also helps prevent surprises within the family and among other stakeholders. Once a successor is named, passed-over members are more likely to take advantage of other career opportunities rather than sustain a sense of false hope (the latter could breed resentment and family tension down the line). Meanwhile, family members who remain in the business will have a clearer understanding of their future responsibilities and opportunities at the company.

Ideally, succession decisions draw on recommendations from key stakeholders. By engaging those parties in a dialogue about the company's future, the business owner improves the likelihood of ultimately obtaining their buy-in, even if at first they don't agree with the owner's choice.

## Train the successor

Whoever is chosen as the successor should have significant relevant business experience. If a younger family member is the identified successor, the individual should go through a substantial apprenticeship. This might include

rotating through various upper-management positions in different business units across the company. Time spent at the company not only allows the successor-in-training to learn the business inside and out, but also helps the person establish his or her credentials with key stakeholders.

It might also be useful for the successor to work outside the family's business before taking the helm. Professional experience outside the company is likely to give the successor a fresh perspective, as well as new knowledge and skills that could benefit the business.

## Delegate leadership authority and company oversight

Singular power in the majority owner may inhibit the organization's ability to grow and adjust to a changing environment. Giving key members of management real authority and including outside members on the board of directors will allow the business to draw from a wider base of knowledge and expertise.

It is also a good idea to encourage key employees to broaden their overall skill sets, in addition to developing certain specialized skills, to help sustain and grow the business. To this end, it may also be necessary to recruit new managers with particular skills (e.g., people with emerging-markets knowhow and skills in new technologies). This can prove difficult for some family businesses. Nearly half of the US participants in PwC's global family business survey (2012/2013) ranked recruitment of skilled staff among their top three internal challenges. By presenting their company as a place where prospective employees will be nurtured and encouraged to grow professionally, family businesses can improve their odds of attracting and retaining top talent.

## ***Brave new world***

### **Grooming tomorrow's leaders for success in the global economy**

Whether a family business operates solely in the United States or is also active abroad, the company's leader needs to be globally savvy.

Many domestic-only US family businesses are part of global supply chains, even if those companies sell exclusively to US customers. When the world economy affects demand, US family businesses feel the pain — or gain, depending which way the pendulum swings. The successor to a family business needs to be alert to these swings and prove agile enough to deal with them.

A family business's competitors are also increasingly global. Aggressive, well-funded companies from fast-growth markets abroad are entering the United States. They're also competing with US companies in western Europe and other mature markets.

Faced with this new breed of competitor, leaders of family enterprises are finding that business as usual won't suffice. To maintain market share, they'll need to differentiate themselves from the competition by creating new products/services, improving current offerings, and finding new ways to reach customers. This calls for innovative thinking and entrepreneurial instincts — qualities that helped the founders launch and build a successful company but weren't necessarily passed down from one generation to the next.



A pioneering spirit is especially useful as family businesses look to emerging markets, where a rising middle class offers attractive growth prospects in the face of slackened demand at home. Emerging markets carry distinct risks, however. Some countries are more risky than others right now, but perhaps not for the long term.

Deciding which emerging markets to pursue requires understanding the various risks in each and how they are likely to change — and then carefully weighing them against the opportunities. The upcoming generation of family business leaders will have to be adept at this if they are to make the most of global prospects.

New leaders needn't go it alone. Joint ventures and other forms of partnering can help move the family business up the learning curve in foreign markets. Collaborations like these may require new thinking on the successor's part if, historically, decision-making has resided chiefly with the family business's leader.

### Determine appropriate business structure and reassess periodically

A good succession plan should consider the most effective ownership structure for the business and revisit it periodically to determine whether adjustments or improvements should be made.

Family businesses can be organized in a variety of forms. These range from the relatively simple form of sole proprietorship to the most formal structure, which is a corporation. Within that range there are also limited liability companies (LLCs) and pass-through entities, such as partnerships.

Many factors should be considered in deciding what is the most appropriate structure for a particular family's business, both at the company's inception and as the business evolves and matures. Prime considerations in choosing a structure include how it will affect the family's ability to (1) raise capital for the business, (2) protect the business's assets from creditors, (3) limit owner liability, and (4) preserve wealth for and transfer it to successive generations.

**Tax considerations:** It is also important to weigh tax factors when determining the right ownership structure. In doing so, a business owner should contemplate the following questions carefully:

- 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 most of its earnings, or will it distribute them?
- 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 activities?
- 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?

These questions should be carefully discussed with experienced tax advisors before a business determines or changes its structure.

**Structuring options:** A family businesses generally prefers to adopt a structure that will allow the business to avoid tax at two levels — the entity level and the ownership level. Therefore, many businesses choose a flow-through structure, such as a partnership, S corporation, or limited liability company.

S corporations are popular for many family businesses. They allow for the inclusion of family members who don't participate in running the business and give owners the flexibility to facilitate the transfer of wealth via certain trusts. However, the complex shareholder structure of an S corporation can become problematic as the family's various generations grow in size.

Similarly, as the generations spread geographically — across the country and around the globe — entire branches of the family may become disconnected. This can result in familial disaffection and operational problems. In these various cases, it might make sense to consider switching to an alternative ownership structure, such as a C corporation.

## *Every business with more than one owner should consider using a buy-sell agreement.*

Recent tax changes are another reason that a family business may consider an alternative ownership structure. For instance, a family business may find that the usefulness of the pass-through nature of an S corporation will be reduced by the recent increases in tax rates for personal income. Consequently, certain S corporations may want to consider converting to C corporation status.

Then too, some family businesses may opt to be structured as LLCs rather than as corporations. LLCs provide the benefit of limited liability for the owners, accompanied by much of the flexibility provided by partnerships. LLCs also allow for the flow-through of losses to the owners, which has been helpful for many companies that struggled during the economic downturn.

Before choosing a structure, a family business should first discuss with experienced advisors the various pros and cons of each alternative. The general characteristics of the various types of business structures are summarized in a chart at the end of this chapter.

### ***Transfer of the business interests***

Family-business owners who do not follow the steps described here often rely on a default plan, whereby the ownership interests are bequeathed to one or more beneficiaries in the business owner's will. Although such designations constitute a "plan" of sorts, announcing a successor in this manner tends to be far from ideal.

A successful transition almost always hinges on a well-considered, written plan that clearly specifies the disposition of ownership interests in the business. The earlier the owner develops the plan, the better. That's because the more time there is to prepare for succession, the greater the opportunity to maximize the business's value and reduce the risks involved when an owner or key employee exits the business.

A written plan should answer multiple questions, including these:

- 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?
- Should ownership and control (i.e., voting rights) be separated?
- Will the planned transfer cause conflicts that should be anticipated and addressed?
- What are the tax consequences of the planned transfer?

Addressing these issues now and reconsidering them as circumstances change will substantially increase the likelihood of a successful transfer of the ownership interests.

In contemplating these matters, a business owner may also want to consider arrangements such as a buy-sell agreement, an equity financing arrangement, or perhaps even an initial public offering, depending on his or her objectives.

### ***Buy-sell agreement***

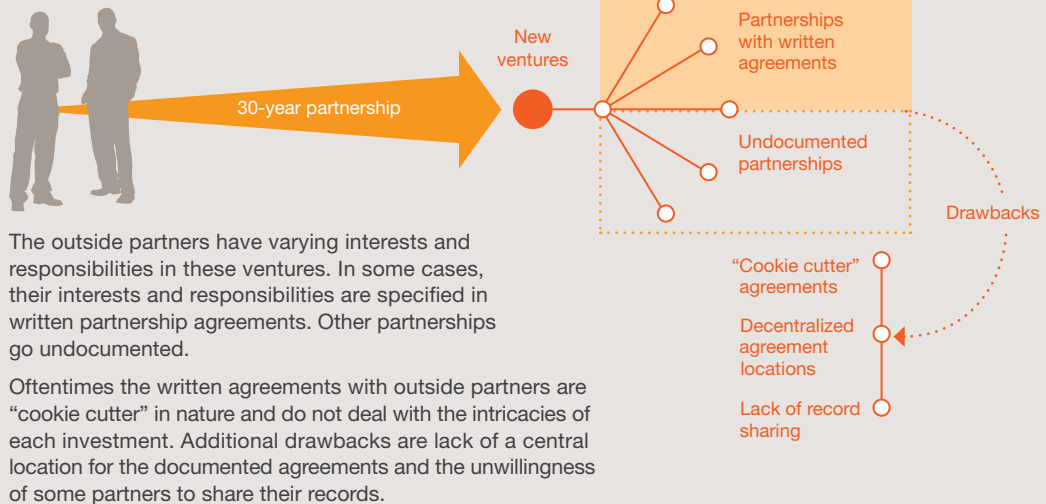
Every business with more than one owner should consider using a buy-sell agreement to describe the terms and process for an orderly transfer of the ownership interests in the event that the owner wishes to sell, becomes disabled, gets divorced, retires, or dies. There are two categories of buy-sell agreements: the redemption agreement and the cross-purchase agreement. Sometimes a hybrid of these two is used.



## Put it in writing

It will make things easier in the long run

Ed is the owner-operator of a small business that invests in various real estate ventures. For more than 30 years, Ed has undertaken many of these ventures jointly with his business associate James. Over time, however, Ed and James's relationship cools, and other partners are admitted to some of the ventures.



The outside partners have varying interests and responsibilities in these ventures. In some cases, their interests and responsibilities are specified in written partnership agreements. Other partnerships go undocumented.

Oftentimes the written agreements with outside partners are "cookie cutter" in nature and do not deal with the intricacies of each investment. Additional drawbacks are lack of a central location for the documented agreements and the unwillingness of some partners to share their records.

Upon Ed's death, his family is left with the task of trying to monetize and transfer the partnership interests. While state law generally provides remedies, they are expensive and time-consuming.

A well-coordinated written agreement with appropriate record retention would have made the process much simpler.

Under a redemption agreement, the business entity purchases the selling owner's interests by using its own cash or debt. The owners will not increase their tax basis, although they will increase their ownership interest.

In a cross-purchase arrangement, the selling owner sells his or her interests to other owners rather than to the business entity. This benefits the buying owner(s) by increasing the tax basis of the purchased ownership interests equal to the purchase price, which can reduce future tax upon subsequent sale of the ownership interests.

In many cases, neither the entity nor the other owners have enough cash to purchase the entire business. Life insurance is sometimes acquired on the owners' lives and can be owned by the business to assist in the redemption of the deceased selling member's interests or, in the case of a cross-purchase agreement, be owned by the entity's individual owners, most likely through a partnership or trust.\*

Buy-sell agreements can be arranged so that the purchases occur either immediately or over an extended period.

### Sale to a third party

If a sale of the business is contemplated, owners must take into account the financial strength of the business; the financial position of potential buyers; available sources of financing; collateral; guarantees; the tax consequences for both parties; and cash flow issues.

The timing of a transfer is another critical consideration. A business owner who is considering selling the business may want to time the completion of the sale transaction in a way that is advantageous for tax purposes. Doing so could result in net after-tax proceeds that are substantially higher than if the deal were to be accelerated or delayed.

To manage these various issues, owners should engage advisors who can help them make effective and timely decisions, as well as give them a detailed understanding of the sale process.

### Initial public offering (IPO)

The number of private businesses looking to access the equity markets has been growing. Reasons a business may decide to go public include the following:

- To access capital markets and raise funds
- To acquire other publicly traded companies
- To attract and retain talented employees
- To diversify and reduce investor holdings
- To provide liquidity for shareholders

However, an IPO isn't necessarily the best way for a business to meet these objectives. A business's key stakeholders should therefore give considerable thought to why going public is appropriate in their particular circumstances. They should also bear in mind that the required preparation in the months leading up to an IPO is significant and can be quite challenging, time-consuming, and expensive — as well as distracting to the business. Less than full preparation is not a wise option: A business that goes public must be ready to meet shareholder, regulatory, and market expectations from the start.

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\* Note that a redemption buy-sell agreement funded by corporate-owned life insurance is generally not a tax-efficient way to transfer ownership upon death. For more on this and other types of buy-sell agreements, see chapter 9 of this guide.

Fulfilling those expectations will be an ongoing responsibility throughout the life of the company. Part of that will entail disclosing details about the company that might never before have been known outside its walls. Family businesses that prize confidentiality may find they aren't comfortable with this level of scrutiny. Thinking through this and other realities of public life well in advance is critical to a successful IPO.

### Lifetime transfers

A number of options for lifetime transfer planning should be modeled and considered for inclusion in a succession plan:

- 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, and to provide alternatives for transferring wealth to family members not involved in the business
- 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

While the tax aspects and consequences of succession planning can be extremely important, owners of family businesses should bear in mind that the nontax aspects of such planning (e.g., who is best suited to run the business; potential family conflicts regarding ownership, involvement, etc.) are usually far more important to the long-term success of the business.

That said, business owners should keep in mind the tax benefits of lifetime transfers. Typically, the estate tax cost of transferring business interests upon an owner's death will be greater than the gift tax cost associated with lifetime transfers of the same business interests.

Indeed, during the owner's lifetime there are generally many opportunities to transfer ownership interests in a way that may avoid gift taxes entirely. Transfers can be structured to permit the business owner to retain control while transferring entity interests and substantially reducing the tax liability.

When the intent is for the junior generation to take over the business, there are many options, including trusts and outright ownership. Appropriate structuring of the lifetime transfers with the end goal in mind is critical.

### Conclusion

The health and longevity of a family business depend on early succession planning — and on communicating the results of that planning in a timely fashion. Planning efforts should be an ongoing process rather than a distinct event. This approach will increase the likelihood that the business will endure well beyond the leadership transition, delivering lasting value to the family and other key stakeholders.

## Overview comparison of entities

	Partnership	S corporation	C corporation	LLC
<b>Liability</b>	Unlimited for general partners	Limited to amounts invested and loaned	Limited to amounts invested and loaned	Limited to amounts invested and loaned
<b>Double taxation</b>	No	No (except for some built-in gains and passive income)	Yes	No
<b>Pass-through of profits and losses</b>	Yes	Yes	No	Yes
<b>Limitation on entity losses deductible by owners</b>	Net investments plus net income plus share of debt	Net investment plus net income plus loans to corporations	None deductible	Net investment plus net income plus share of debt
<b>Subject to passive activity loss rules</b>	Yes	Yes	Only certain small C corporations	Yes
<b>Tax rates</b>	Income taxed to owners at marginal tax rates, plus an additional 0.9% on active income from partnerships and 3.8% on investment income*	Income taxed to owners at marginal tax rates, plus an additional 0.9% on wages and 3.8% on investment income*	15% on first \$50,000, increasing to 34% over \$75,000 and 35% over \$10 million	Income taxed to owners at marginal tax rates, plus an additional 0.9% on active income from partnerships and 3.8% on investment income*†
<b>Special allocations</b>	Possible, if there's a substantial economic effect	No	Possible, if tracking stock is issued	Possible, if there's a substantial economic effect
<b>Fiscal year</b>	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	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
<b>Tax-free fringe benefits to owners</b>	Limited	Limited	Permitted	Limited
<b>Public offering</b>	Yes, but with some difficulty	No	Yes	Yes, but with some difficulty
<b>Tax-free merger with corporations</b>	Yes, under certain circumstances; additionally, possible tax-free incorporation available	Yes	Yes	Yes, under certain circumstances; additionally, possible tax-free incorporation available
<b>Accumulated earnings tax</b>	No	No	Yes	No
<b>Personal holding company tax</b>	No	No	Yes	No

\* The additional tax on active income and investment income applies to income received in excess of \$250,000 for married couples filing jointly, \$125,000 for married couples filing separately, and \$200,000 for individuals.

† The additional 3.8% applies only if the adjusted gross income exceeds specified thresholds.

A close-up portrait of a woman with blonde hair and blue eyes, wearing a light grey blazer over a patterned top. In the background, a man in a dark suit and blue shirt is visible, slightly out of focus. The text "Family meetings" is overlaid in orange script font on the right side of the image.

# *Family meetings*



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**Ch6** A successful family meeting is one that encourages open dialogue and trust.

Families with significant wealth recognize the importance of managing their investments, charitable giving, and trusts with an eye toward successive generations. By taking a multigenerational approach to such matters, families help to ensure that younger members understand how effective wealth management both reflects and supports the family's values, meets its near-term financial goals, and preserves the family's estate for future generations. Often, however, families don't have an adequate mechanism for imparting this knowledge. Family meetings can fill that breach.

### ***Heightened need***

While the importance of educating younger generations about wealth management is nothing new, the need for such education has increased in recent years. Families are realizing that they can no longer rely on their wealth management plans to run on autopilot or with minimal oversight. New, novel, and complex investment products — and their use in untraditional approaches that might be incompatible with growing and preserving a family's wealth — make it necessary for families to both understand and be actively engaged in wealth management decisions made on their behalf.



As a result, relatively static plans that were passed down from one generation to the next, with only minor changes, are now being replaced by more-dynamic plans — ones that take into account today's economic backdrop, anticipated tax rate changes, and legislative uncertainty. High-net-worth individuals may therefore have to be more knowledgeable about macroeconomics, governmental policy, and the principles of investing and tax planning than perhaps they had to be in the past. They will then have to pass that knowledge on to the next generation so that junior members may preserve the family's wealth well into the future. Family meetings, if properly orchestrated, can be an effective way of doing this.

### ***Main points to discuss at a family meeting***

Communicating the family's investment and tax planning strategies to younger generations is often a key reason that a patriarch or matriarch calls a family meeting. The meeting may also serve as a forum for discussing estate plans, charitable giving, and managing the family's risk exposure (e.g., through effectively using insurance products and applying other asset-protection techniques). Historically, senior members of high-net-worth families have met with outside advisors to discuss these matters, generally with little input from junior members. Some families, however, have begun bringing children, adult grandchildren, and even in-laws into these discussions.

Family meetings tend to address the following issues:

- Inheritance — who gets what, when, and why
- Succession planning for the family business and/or foundation
- Investment priorities, tax planning, and other wealth management considerations
- Philanthropy

As changes occur in each of these areas, subsequent family meetings should be held to discuss how the modifications affect the family's vision for what it wishes to do with its wealth. Ideally, the family will already have a wealth mission statement. If it doesn't, the first family meeting could be devoted to creating one.

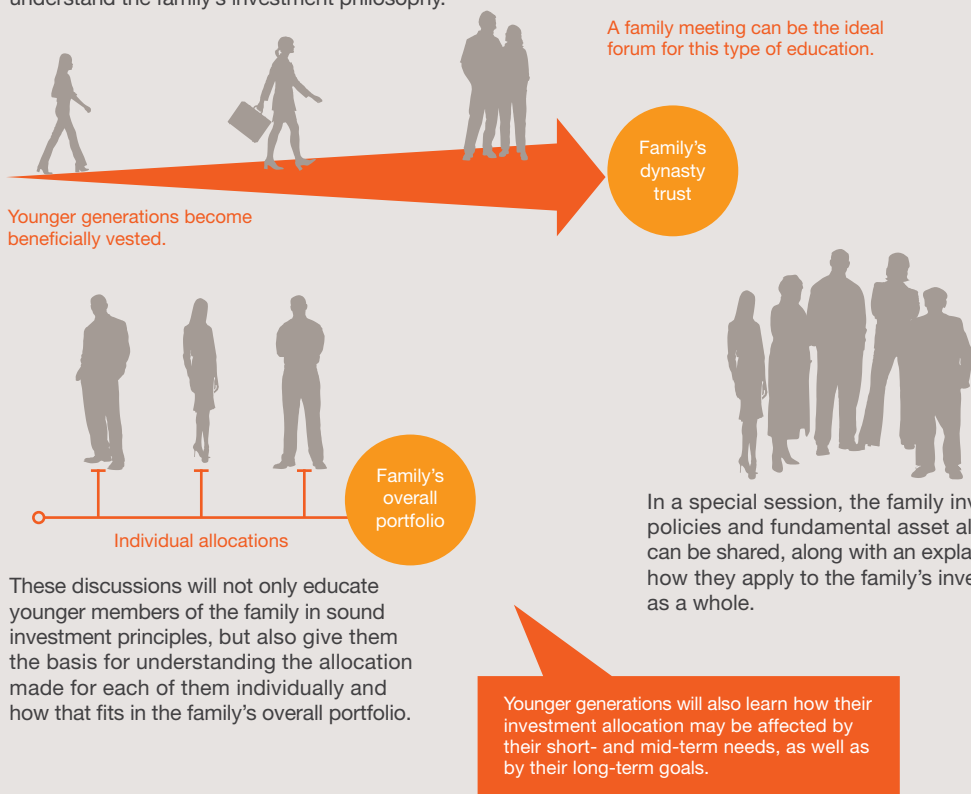
The mission statement should outline the family's wealth transfer objectives, broader family goals, philanthropic concerns, leadership structure, and governance principles — all of which should clearly reflect the family's value system. Indeed, defining its unique set of values may be the first step in the mission-drafting process if a family hasn't already carefully contemplated the matter. Those values, along with the accompanying goals in the mission statement, should reflect both the family's near-term objectives and its long-term vision. In this way, multiple generations will have a stake in the family's mission, increasing the likelihood that they'll assume responsibility for honoring and maintaining it.



## Family investing 101

### Educating the next generation

As younger generations mature and start to beneficially vest in the family's dynasty trust,\* it becomes increasingly important that they understand the family's investment philosophy.



\* A dynasty trust can provide for multiple generations far into the future.

*If a family member chooses to chair or facilitate the meeting, it is best that the person isn't also the head of the family or the de facto leader.*

Families that hold meetings have generally done so on an annual basis. Now, however, some families have been finding it beneficial to meet more frequently so they can assess the effect that economic and legislative developments are having — or may have — on their wealth management. Such meetings present good opportunities for educating younger family members on how developments today — such as passage of new laws and tax policies — will impact the family's wealth in critical ways down the line.

### ***Deciding who runs the meeting***

A good facilitator is critical to having a successful family meeting. As a rule, choosing a neutral, outside party for this role enables all family members to feel comfortable voicing their opinions, particularly junior members, who might feel intimidated if the head of the family were to preside over the meeting. Some facilitators have been specially trained to guide family meetings — they may be helpful to have on hand if a family is holding a meeting for the first time.

If a family member chooses to chair or facilitate the meeting, it is best that the person isn't also the head of the family or the de facto leader. Instead, the facilitator role could rotate through family members, with a new person presiding at each meeting. Such an approach would promote a sense of inclusion and shared responsibility, downplaying hierarchical divisions.

Regardless of who runs the meeting, that person should be adept at moving past rough spots, working through any conflicts that arise, bridging communication gaps between generations, and making sure everyone is heard. Flexibility and strong diplomatic skills are therefore required on the part of the facilitator. Ideally, that person will also be good at communicating things in plain English, particularly since some of the financial and tax matters addressed could be complex.

For the meeting to be a success, everyone should come away from it with a good understanding of what was discussed.

### ***Who should attend?***

Once it is agreed that a family meeting is desirable, there is the matter of deciding who should attend. Some family meetings include children, adult grandchildren, and spouses, while others do not. Generally, who's invited depends on the issues that will be discussed and how each group is likely to be affected by what's decided.

When multiple generations are in attendance, it is important for participants to keep in mind that the way some members view the family mission may be completely different from how others view it. The more meetings the family holds, the more opportunity various members will have to exchange views, appreciate (and learn from) one another's perspectives, exercise persuasion, perfect the art of compromise, and ultimately agree on common goals that keep the family mission current and relevant.

### ***Elements of a successful meeting***

Setting the stage sufficiently ahead of time is critical to having things run smoothly on the appointed day. By the time that date arrives, everyone should know why he or she is in attendance and what the meeting is meant to accomplish, as well as what it's not meant to accomplish. To that end, it should be made clear in advance how much financial information will be shared. This will help ensure that family members who aren't in control of the wealth don't come to the meeting with false expectations about what they'll learn.

It is recommended that in addition to apprising everyone of the meeting's topics and goals beforehand — in the form of a structured agenda — the meeting's organizer also obtain everybody's input and signoff on the agenda. Equally important is selecting a time, place, and date that enable everyone to attend. If possible, choose a neutral setting, so that all involved will feel comfortable expressing their opinions and concerns. A resort, for instance, might make a better setting than the home of the matriarch or patriarch.

A successful family meeting is one that encourages open dialogue and trust. With that in mind, it's important that the agenda is designed to support everyone's involvement in the day's discussions. As already noted, an outside facilitator can be useful in this respect, especially if the head of the family tends to talk over other family members. If the younger generation feels too intimidated to raise certain questions, then misconceptions they might have won't be dispelled, which could compromise their ability to steward the family's wealth in the future.

One way to avoid such situations is to set ground rules. Emphasize that people need to listen to one another, quell the urge to interrupt, and speak respectfully, even when discussing contentious points. Conclude the meeting with a review of all the agreed-upon decisions, concur on which issues remain unresolved, and then decide how those issues will be managed between then and the next meeting.

It is especially important to have a designated family member take minutes at the meeting so that there is a written record of the items discussed and important decisions reached. The minutes should be shared with the participants, as well as with invited family members who were unable to attend the meeting. This serves a dual purpose — not only does it provide documentation in the event of a dispute, but it also preserves the family's history for future generations.

*One meeting does not, in itself, constitute success. Families should meet routinely.*

### **Outcomes**

The real work begins when the meeting ends. Family members will need to show that they are committed to accomplishing the goals asked of them during the meeting. They should routinely update the facilitator about progress made toward achieving those goals, so that he or she can then inform the group as a whole.

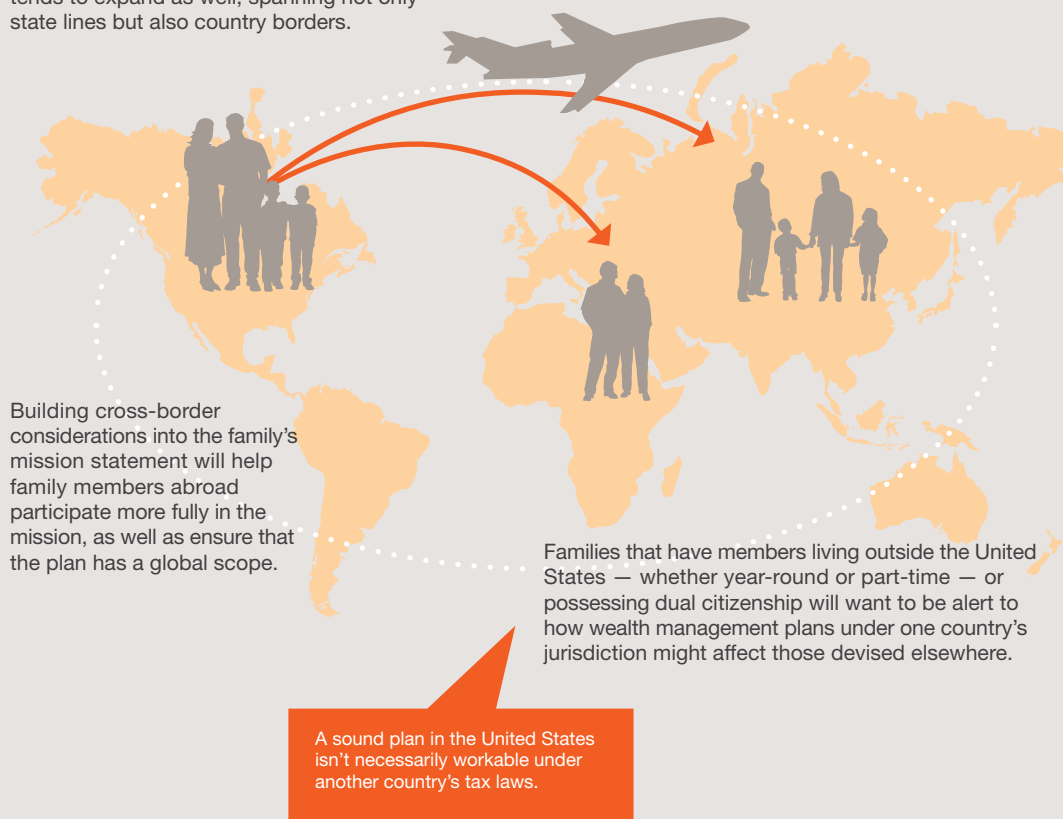
### **Conclusion**

At the end of the day, a successful family meeting is one in which everyone openly participates and agrees to work collectively toward achieving the family's shared objectives. However, if your first family meeting doesn't go smoothly, that doesn't spell failure. Families can be every bit as complex as the wealth management strategies they apply, so it's unrealistic to expect perfect harmony at the first family meeting. Likewise, it is important to understand that one meeting does not, in itself, constitute success. Families should meet routinely. Doing so is essential to achieving the family's mission today and to educating the younger generations in how to fulfill it tomorrow.

## World view

### Cross-border considerations for international families

As families grow, their geographic reach tends to expand as well, spanning not only state lines but also country borders.



# *Family offices*







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**Ch7** The managerial and administrative needs of high-net-worth families can be extensive.

Family offices as we know them first emerged during the Industrial Revolution: American families such as the Rockefellers and the Mellons quickly amassed large fortunes that soon became too unwieldy to manage without a centralized mechanism. Over time, the responsibility of family offices has expanded beyond coordinating the many various aspects of wealth management to include additional services, such as running foundations and overseeing other legacy-building endeavors. Today's high-net-worth families are also increasingly relying on family offices to deal with ever-more-complex tax issues, arcane investment innovations, and global holdings. Of course, not everybody needs so broad a range of services as the ones just noted, which is why family offices in the United States are as versatile as US families are varied.



### ***The comfort of continuity: What a close-knit advisory team provides***

Regardless of whether they use a family office or not, almost all high-net-worth families rely on external advisors to take care of their extensive wealth management needs. Those advisors usually include an attorney, accountant, insurance broker, and investment manager.

Although they may have numerous professional qualifications, your advisors' most important qualities are their understanding of your goals and motivation to achieve them. In researching potential advisors, therefore, you should look not only at their skills and certifications, but also at how well their overall approach is likely to support your particular goals.

Personal recommendations from trusted sources make a good starting point, but make sure that you also do your due diligence. Analyze the potential hiring of a new advisor as carefully as you would any major business decision:

- Review the advisor's résumé, qualifications, certifications, licenses, background, years of experience, and referrals
- Call references, but also check to see if the advisor has any formal complaints against him or her
- Request the tax and income profiles of the advisors' other clients; those profiles will indicate whether your circumstances are the type that the advisor is accustomed to addressing
- Determine the range of services the advisor provides
- Make sure that the advisor's investment goals are compatible with yours and take into account your risk tolerance; ask how the advisor is paid for services

- Assess an advisor's objectivity and the likelihood that particular products and services will be offered primarily because the advisor benefits from those offerings

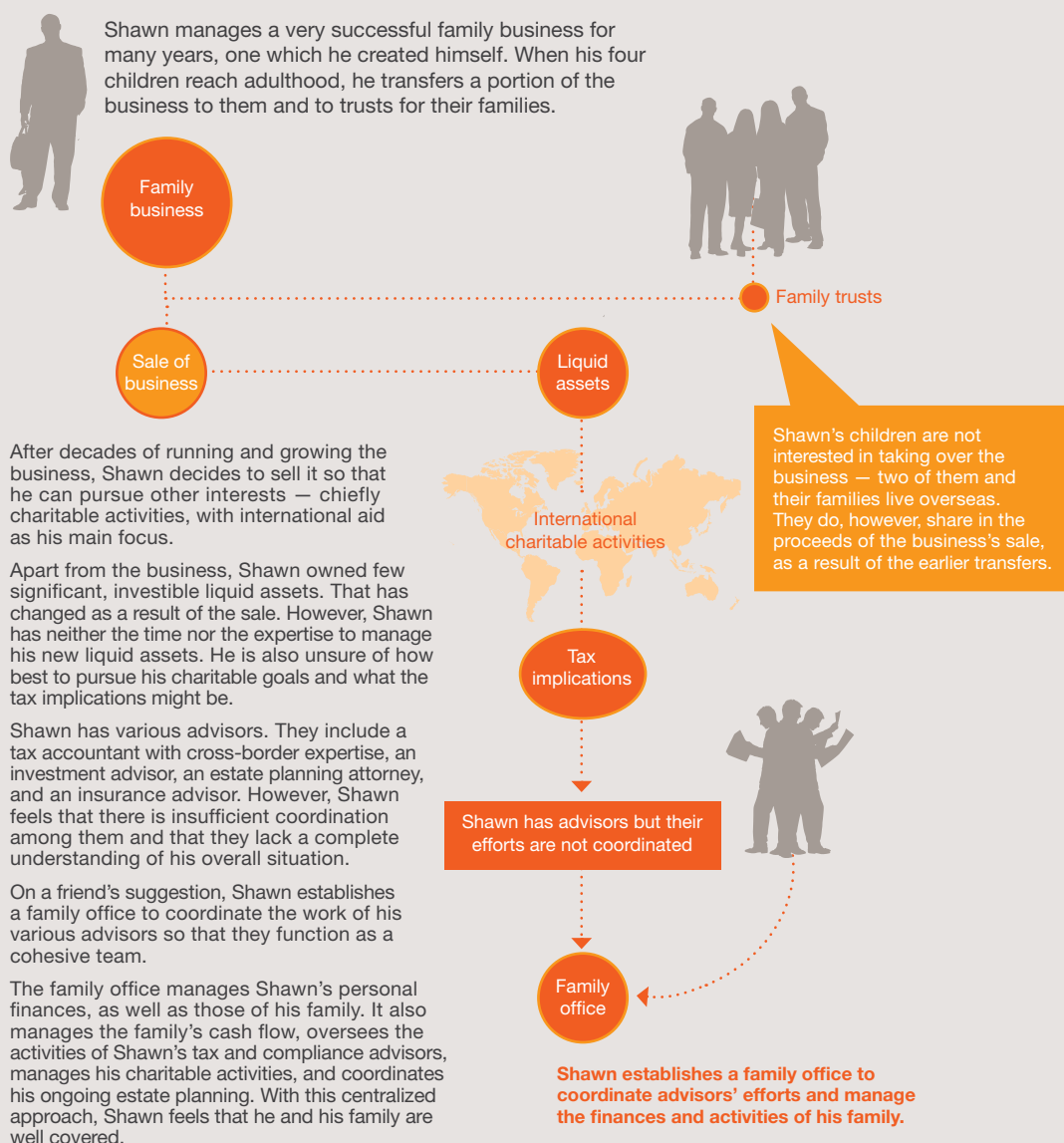
Ideally, your wealth management advisors function collectively as a core advisory team — rather than function in silos — with one of the advisors acting as the point person to coordinate the activities of the group as a whole. Setting up a family office is often the most effective way to enable and enhance that coordination, as well as ensure continuity of efforts. The point person's job is to:

- Steer the team in crafting a wealth management strategy that you believe is appropriate for you and your family
- Routinely provide you with a bird's-eye view of your wealth management plan so that you can gauge whether it remains consistent with your overarching goals
- Make sure the wealth management plan is well documented and that each advisor understands how the plan impacts his or her particular area
- Lead the team in implementing the plan and make sure nothing is overlooked

A well-coordinated advisory team, coupled with a family office, frees up family members' time so that they can focus on the family business, new philanthropic projects, outside careers, and other pursuits. A family office is especially useful for families whose wealth management activities involve multiple and complex entities, such as family partnerships, trusts, family businesses, and foundations. In some cases, there may also be a specific catalyst that prompts (or hastens) the opening of a family office — an approaching liquidity event, for instance.

## Bird's-eye view

How a family office brings the big picture into focus



## *The range of services that a family seeks will determine how comprehensive or narrow a family office model they need.*

Once a family office is established, it is likely to serve multiple generations, across which there may be a range of different needs that require various wealth management strategies. A well-run family office successfully synthesizes these strategies to ensure that they support the wealth management goals of the family as a whole.

### **Structure and creation**

How a family office is structured depends, in part, on how many families it serves. There are two main categories of family offices: the single-family office and the multiple-family office. Beyond this distinction, the way a family office models itself varies with the nature of the families it serves. Some families may desire only basic administrative help, whereas others may want the family office to oversee asset management or perhaps even run their daily affairs. The range of services that a family seeks will determine how comprehensive or narrow a family office model they need (e.g., an administrative, hybrid, or comprehensive model).

A family office is often organized around clusters of activities, including the following:

#### **Investment-related activities**

- Asset allocation
- Manager selection and monitoring
- Due diligence
- Strategic analysis
- Risk management

#### **Asset consolidation**

- Global custody
- Consolidated asset reports
- Shadow asset reporting
- Performance and benchmark analysis
- Strategic analysis

#### **Tax and legal services**

- Personal level
- Entity level
- Income tax planning and compliance (domestic and international)
- Gift and estate planning
- Entity structures

#### **Philanthropy**

- Philanthropic mission
- Charitable planning
- Grant-making
- Investment oversight

#### **Family legacy**

- Family mission statement
- Leadership development and succession planning
- Educating family members (e.g., about the family mission, philanthropic goals, cross-generation wealth management goals)

### Administrative services

- Banking
- Financial administration
- Information aggregation and reporting
- Trust accounting
- Bookkeeping and accounting
- Pooled partnership accounting
- Technology solutions and support services

### Other services

- Gate-keeping (controlling which individuals and entities have access to the family and its information)
- Security
- Concierge services
- Family risk management (insurance)
- Trustee services
- Board development
- Coordinating and overseeing activities of external advisors
- Implementing and monitoring internal controls

Typically, the lead family member and a key outside advisor work together to decide the main objectives of the family office. Those objectives will dictate which services the office provides and how it is organized, staffed, and technologically supported. The legal structure (partnership,

limited liability company, S corporation, etc.) will also have to be decided, as will the office's initial funding, anticipated operational costs, and allocation of costs among family members. Other key decisions concern the size and location of the office, who will run it, and how the office will keep the family informed of its activities.

### *Single-family office versus multiple-family office*

A single-family office (SFO) generally affords a family greater privacy and independence than an office that is shared with other families, as well as allows for a more-tailored business model. SFOs can be expensive, though, as the cost of recruiting and retaining people with the right skills (some of them highly specialized) continues to increase. To spread that cost across a larger base of assets and income, many families turn to the multiple-family office (MFO).

MFOs operate in much the same way as SFOs. However, MFOs tend to employ larger staffs, whereas an SFO may be somewhat resource constrained. Also, MFOs generally have well-established relationships with third-party vendors (which take time for a newly established SFO to build), allowing an MFO to achieve a good balance between in-house and outsourced services. Another advantage to using an MFO is that it typically will have transparent prices and attract top talent. In catering to more than one family, however, an MFO must guard against spreading itself too thin (so that quality is not compromised) and take extra care to maintain the confidentiality of each family it serves.

Many investment banks have established affiliates that offer commercial MFOs to high-net-worth clients and their families. Commercial MFOs offer the benefits of a small family office with the added benefits of a large, established wealth management firm, including broad experience, deep knowledge, and extensive resources. Commercial MFOs will ideally put their clients' investment goals above the objective of selling the products of the MFO's parent company.

Within each of these structures, a family has to decide on the nature and breadth of services it wants the family office to supply, ranging from purely administrative support to a comprehensive suite of services. The family office structures discussed here can accommodate a variety of different service models.

### ***Ongoing operations***

The focus of the family office is often on the growth and preservation of the family's wealth, with an eye toward ensuring sufficient assets for subsequent generations. Offices that take this approach coordinate the different investment plans of individual family members — so that, for instance, the plans of parents and grandparents are taken into consideration during the preparation of investment plans for children and grandchildren (who are likely to inherit much of the senior generation's assets). This focus lends itself to helping younger generations gain an understanding of the family's wealth mission and to becoming involved in fulfilling it.

Much like a closely held business, a high-net-worth family benefits from setting goals (both short-term and long-term) and then routinely reviewing them. At a minimum, a family should meet on an annual basis to formally discuss its wealth management goals and assess the prior year. Any change in the family's priorities or wealth management objectives should be communicated to the family office's manager and other key advisors so that the changes can be executed and the family's wealth management plan modified as needed.

As the number of family offices increases, more resources are becoming available to them, including family office networks and conferences, as well as various family office organizations and communities. These communities can provide guidance and information on best practices for effectively managing a family office.

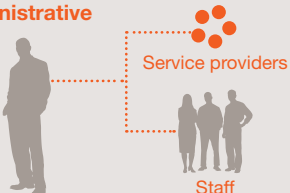




### ***Family office administration***

The role of the family office is defined by the family's overall objectives. Managers and advisors will therefore adapt to fulfill a family's goals as its objectives evolve over time. An effective family office will also have a governance structure in place that complements the expectations of the family by adhering to the family's expressed mission. In addition, successful managers and advisors often play a supporting role as key facilitators in the decision-making that helps a family meet its objectives.

## Family office models – which one to choose?

When a family is deciding which family office model best suits its needs, it often has to weigh factors such as cost against other variables, including control, privacy, and scope of services.

Here are three examples of family office models that focus on different sets of family needs.

Family office model	What it does	Average size
<b>Administrative</b> 	<p>Advisory and investment services are managed through contracts with external service providers.</p> <p>Typically, the administrative family office directly employs staff to provide some level of bookkeeping, tax, or administrative services – often on a part-time basis.</p>	<b>\$50M-\$100M</b>
<b>Hybrid</b> <div> <div> <b>Strategic</b>  </div> <div> <b>Nonstrategic</b>  </div> </div>	<p>Strategic functions tied to the family's objectives are managed in-house, while nonstrategic, administrative functions are outsourced.</p> <p>Family members may be employed for certain strategic activities.</p> <p>Hybrid family offices tend to employ experts in tax, legal, and/or asset allocation matters.</p> <p>Certain investment management functions may be kept in-house, particularly when they leverage a family's industry expertise – e.g., real estate investing.</p>	<b>\$100M-\$1B</b>
<b>Comprehensive</b> <div> <div> <b>In-house staff</b>  </div> <div> <b>Outsource</b>  </div> </div>	<p>All functions, including administrative, tax, legal, risk management, and core investment management, are provided by in-house employees.</p> <p>Specialized investment management activities such as hedge fund, venture capital, private equity, or emerging-market investments may be sourced externally.</p> <p>The office may actively be looking to take on additional single-family offices and form a multi-family office.</p>	<b>\$1B+</b>

## *A family office aligns strategic tax planning with a family's investment plan.*

Mutual trust is critical to ensuring the right tone and direction of the family office as it addresses the needs of various family members. The family should be confident that decisions are made to support its vision while managers create a positive culture that matches the family's expectations. The creation of a mission statement can be helpful in clarifying and guiding all parties in their respective roles and responsibilities within the family office and in building a framework to support the family's vision.

### ***Technologically savvy family offices***

The technology platform (or combination of platforms) used by a family office affects the efficiency and functions of the office's personnel. Today there are a variety of platforms and software systems available to family offices. Beyond facilitating internal operations, these platforms also help the office communicate effectively with all generations of the families it serves — including members that prefer to rely on new and fast-evolving forms of electronic communication, such as social media.

These newer communication platforms, however, bring with them a host of security issues that family offices must now keep in mind, especially where the transmission of confidential information is concerned. When evaluating technology platforms, therefore, family offices and the clients they support

should consider not only daily reporting functions and communication needs, but also what security controls to implement. Implementing policies and procedures to mitigate threats is key and has become a large focus for family offices. Areas that family offices have been giving greater attention to include disaster-recovery plans, monitoring of family members' "Web footprints," secure transfer of documents through Web portals, and upgrading of technology systems.

### ***Tax considerations***

A family office aligns strategic tax planning with a family's investment plan. It does this to ensure that the investments chosen for the family are tax efficient. One of the tax planning strategies that a family office might pursue is to have a number of the family members be represented as a single unit, since this can result in various tax efficiencies.

A family office can also evaluate the tax implications of wealth transfer and estate planning, including in light of recent changes in the laws governing estate and gift taxation. Because a family office focuses on multigenerational wealth transfers, it readily assesses possible strategies such as yearly gift plans and the creation of various trusts. In doing so, it keeps scheduled or potential legislative changes in mind.



Families that have their own business may be able to treat family office expenses as relating directly to the ongoing operations of the business. In circumstances that allow this treatment, some of the associated costs may be deducted “above the line” (i.e., be fully deductible) rather than treated as miscellaneous itemized deductions. Because only business expenses that are over 2% of adjusted gross income may be treated as miscellaneous itemized deductions, many high-net-worth taxpayers will receive no tax benefit for such deductions (e.g., accountant and attorney fees). Above-the-line deductions do not come under this limitation and therefore present a tax-savings opportunity for qualifying family offices. Family offices that support a family business may also be able to pursue opportunities to set up tax-deferred retirement plans.

### **Conclusion**

While every family is different, the mission of all family offices is nearly always the same: to facilitate the wealth management of a family so that its short-term needs are adequately met in tandem with achieving the family’s long-term goals. The precise nature and balance of those needs and goals — along with the scope of a family’s wealth and activities — are what will ultimately determine how best to tailor a family office’s structure and function to a particular family’s circumstances.

A group of people, including a woman lying down and several children sitting, are on a grassy mountain slope. In the background, there is a large, rugged mountain with significant snow cover under a clear blue sky. The scene is bright and sunny.

# *Cross-border tax considerations*





**Ch8** As world markets become increasingly intertwined and the global reach of families widens, taxpayers will need to be ever more aware of cross-border considerations.

### *The importance of getting it right*

Globalization is an important factor in today's tax planning. International assignments for US executives, children studying abroad, and families with multiple citizenships and residencies mean that taxpayers and their advisors need to be increasingly aware of cross-border considerations in their tax planning and compliance.

While many cross-border investments and transactions may appear standard, they could entail unforeseen complexities in tax reporting. It is essential, therefore, that US taxpayers\* and their advisors thoroughly understand the reporting responsibilities associated with foreign investments and interests in foreign entities. US taxpayers living outside the United States will need to be alert to special issues arising in estate planning, while US taxpayers with noncitizen spouses will have special issues of their own to address. And then there are special considerations when individuals immigrate to, or expatriate from, the United States. This chapter discusses the importance of getting these and other issues right in your cross-border tax planning so that you are being both tax efficient and compliant with tax regulations.

\* US taxpayers include (1) US citizens and residents, (2) entities (corporations, partnerships, LLCs, etc.) created under the laws of the United States, and (3) estates and trusts created under US laws.

## Income taxation considerations

### US citizens and US tax residents

The United States taxes its citizens on income regardless of where that income is derived. Therefore, a US citizen may live abroad and work for a non-US company, but the income earned would still be subject to US income tax and possibly be taxed in the foreign jurisdiction too.

What makes the US tax regime unique is that not only does it tax US citizens on their worldwide income, but it also taxes non-US citizens (“noncitizens”) who are considered *US income tax residents*. US income tax residents include permanent residents who hold green cards, as well as foreign individuals who are not green card holders but spend more than a specified number of days in the United States over three consecutive calendar years. If a foreign individual meets the “physical presence” test and no tax treaty relief is available, the foreign individual is treated as a US income tax resident and taxed on worldwide income.

An individual visiting the US temporarily for a short-term work assignment may inadvertently become a US resident under the “physical presence” test by extending the stay (e.g., with a vacation in Florida). In such cases, if the foreign individual exceeds the number of days that he or she is allowed to remain a nonresident for US income tax purposes, that person would not only have to pay taxes on worldwide income, but might also have to fulfill substantial reporting and tax compliance responsibilities under US rules. Foreign individuals who are aware of these rules before accepting a short-term assignment can take steps to avoid assuming US tax resident status or else engage in tax planning that would lessen the tax effect of assuming that status.

For individuals contemplating moving to or spending significant time in the United States, it is vital that they seek pre-immigration advice in order to mitigate potentially unwelcome tax consequences and to reduce tax reporting challenges.

### Nonresidents

Like many countries, the United States has a tax system that encourages foreign investment in its economy. Noncitizens who do not reside in the United States are subject to US income tax only for income that is derived from a source in the United States (this is not the case for US citizens and US tax residents). Nonresident taxpayers who have US-sourced income often benefit from relief provided under US law and income tax treaties between their home country and the United States. Tax treaties often have provisions that permit certain types of income to be excluded from US taxation or that subject the income to lower tax rates.\*

Some types of US-sourced income (e.g., dividends from US corporations) are subject to US tax withholding, which in most cases means that a nonresident taxpayer may fully satisfy his or her US tax obligations vis-à-vis such income without having to file a US tax return.

### Rules impacting taxation of income

Taxation of worldwide income increases the chance of income being taxed by multiple jurisdictions. To mitigate this risk, the US tax system provides various forms of relief for US citizens and US tax residents whose income is being subject to double taxation. The most common forms of relief are foreign tax credits. Foreign tax credits provide US citizens and US resident taxpayers with a credit against their US income tax for taxes paid to foreign jurisdictions on income sourced outside the United States.

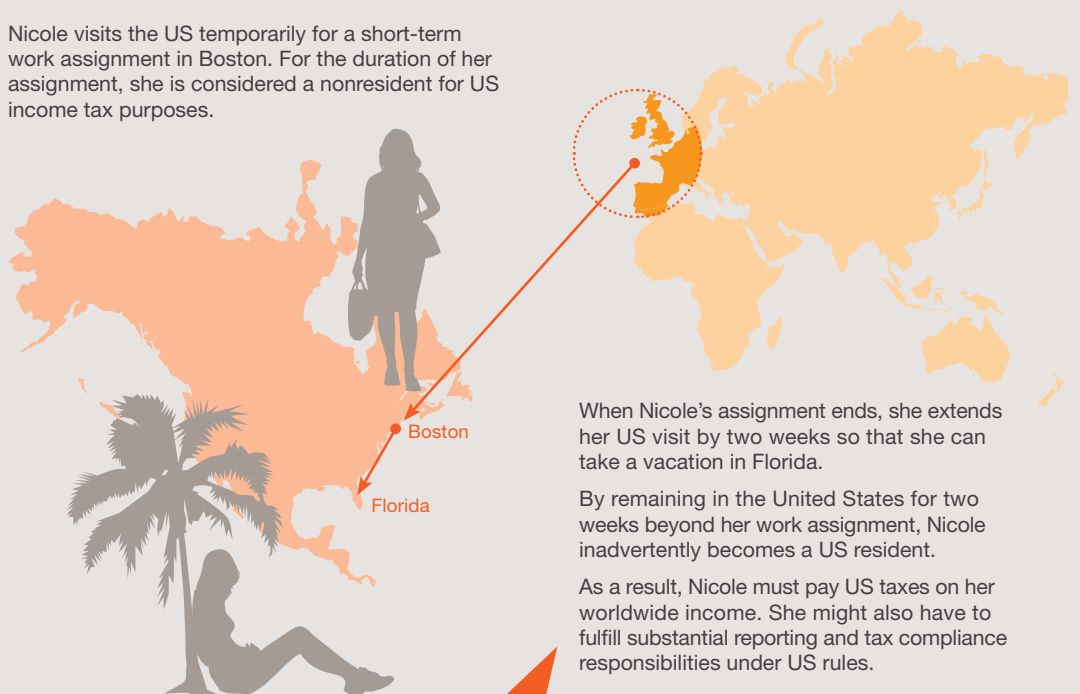
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\* A tax treaty is an agreement between two countries to mitigate the effects of double taxation and may cover income taxes, estate taxes, and other taxes.

## Accidental citizen

The unintended consequence of adding vacation time to a foreign work assignment

Nicole visits the US temporarily for a short-term work assignment in Boston. For the duration of her assignment, she is considered a nonresident for US income tax purposes.



When Nicole's assignment ends, she extends her US visit by two weeks so that she can take a vacation in Florida.

By remaining in the United States for two weeks beyond her work assignment, Nicole inadvertently becomes a US resident.

As a result, Nicole must pay US taxes on her worldwide income. She might also have to fulfill substantial reporting and tax compliance responsibilities under US rules.

Nicole could have avoided assuming US tax resident status if she had consulted a tax advisor before starting her US assignment. A tax advisor can also suggest ways that Nicole might lessen the tax effect of her new residency status.

Another form of relief for US taxpayers who are subject to double taxation is the foreign earned income exclusion. Under this exclusion, US taxpayers residing overseas can exclude from taxation up to \$97,600 (for 2013) of foreign earned income, as well as exclude certain housing expenses, as long as specific criteria are met.

US taxpayers living and working in high-tax jurisdictions, such as Japan and most European countries, should consider whether claiming foreign tax credits alone on earned income is more beneficial than claiming foreign tax credits along with taking advantage of the exclusions. Qualified tax advisors can run projections to determine the most beneficial approach in each case for multiple years.

Another key consideration for people subject to taxation in multiple jurisdictions is the timing of foreign tax payments for the purpose of claiming foreign tax credits. Failure to plan the timing of foreign tax payments properly can result in a mismatch between tax years for when the income was earned versus when the tax is paid. This could have the effect of income being subject to double taxation in the year it was earned, but the taxpayer receiving the credit for the foreign taxes paid in a subsequent tax year when the taxpayer might not have foreign income, meaning that he or she would not be able to use the foreign tax credit.

Also, foreign jurisdictions are often on a different tax calendar, increasing the likelihood of mismatches. The rules for US foreign tax credits recognize this fact and provide flexibility in the form of foreign tax credit carryforwards to future tax years and carrybacks to previous tax

years. There are limitations though, which is why planning is particularly essential for individuals paying taxes in jurisdictions that follow a fiscal tax year.

The other important form of relief is provided by tax treaties between the United States and foreign jurisdictions. The United States does not have income tax treaties with all countries. It does, however, have negotiated tax treaties with various countries to provide relief from double taxation and to give guidance on which jurisdiction has the primary right to tax income. Accordingly, US taxpayers with income from a country that has a tax treaty with the United States should work with their advisors to ensure that income is appropriately sourced under the treaty to manage their global tax burden.

Note that relief from double taxation is not always available at the state level, since some states do not necessarily follow the federal rules with respect to tax treaties or allow foreign tax credits.

### **Foreign investments**

Many US taxpayers invest in foreign assets. Investing directly in foreign assets is permitted under US tax rules but often requires additional reporting and compliance (i.e., additional forms to fill out). In addition, the US income tax regime has a complex set of anti-deferral rules, which often prevents investors from achieving the desired tax benefit of investing in foreign assets. Accordingly, it is important to structure investments in foreign assets appropriately to retain the benefits of the investment while avoiding some of the penalty provisions that can apply to foreign assets.

## *Currency gains can crop up unexpectedly, as in the case of a foreign mortgage for a foreign personal residence.*

### **Foreign corporations**

Placing assets in a foreign corporation may have the effect of deferring income until the corporation declares a dividend. Since the corporation is foreign, the income earned in the foreign corporation will not be subject to US income tax (unless the corporation is earning US-sourced income). Therefore, the income earned in the foreign corporation is deferred from being taxed by the US tax authorities.

To prevent US taxpayers from incorporating overseas for the purposes of deferring income tax to a later year, the US tax authorities have developed anti-deferral rules applicable to closely held or controlled foreign corporations that generate primarily passive income. The rules can result in US taxpayers having to report their pro rata share of corporate earnings on a current basis, regardless of whether the foreign corporation distributes such earnings. Alternatively, the rules sometimes allow for deferral but subject the income, when received, to the highest tax rates and an interest charge.

The primary anti-deferral rules for corporations apply to what are known as passive foreign investment companies (PFICs) and controlled foreign corporations (CFCs). Keep in mind that certain seemingly innocuous investments, such as foreign mutual funds, are typically treated as PFICs. Furthermore, ownership of a PFIC or CFC can result in considerable informational reporting.

As with all informational forms required by the US tax authorities, failure to complete and submit tax forms for income from foreign corporations can result in steep penalties. US taxpayers should consider whether the benefits of these corporate structures outweigh the unfavorable treatment under the US tax code.

### **Foreign currency exchange gain**

Investing directly in foreign currency is another investment strategy that some taxpayers employ. In recent years, the currency markets have seen extensive volatility, creating great investment opportunities but also exposing US taxpayers to currency exchange gains and losses. Currency gains can also crop up unexpectedly, for example, in the case of a foreign mortgage for a foreign personal residence or in the case of cash balances that are not otherwise considered income-producing.

Typically, for purposes of US income tax, gains and losses realized on currency transactions are not treated as capital transactions that are subject to preferential capital gains tax rates. Instead, they are taxed as ordinary income. Additionally, foreign exchange currency losses beyond certain thresholds may also be subject to additional federal (and sometimes state) disclosure requirements. Therefore, it is critical that a US taxpayer be aware of not just the benefits of investing in foreign currency and foreign personal residences, but also the pitfalls of these types of investments. Making your tax advisor aware of such investments will put him or her on notice to handle the taxation of these items appropriately and make sure that the tax reporting associated with them is complete.



## *US taxpayers may unknowingly subject themselves to tax on transfers of property to foreign entities and trusts.*

### **Foreign trusts and estates**

US taxpayers who establish or are beneficiaries of foreign trusts may face unanticipated tax consequences and significant reporting obligations. A US taxpayer who creates a foreign trust over which he or she has no control may nevertheless continue to be subject to tax on all income and gains on the transferred property under the grantor trust rules. Generally, these rules provide that transfers by a US taxpayer to a foreign trust with US beneficiaries result in the US taxpayer being treated as the owner of the trust for tax purposes.

Beneficiaries who receive distributions from foreign nongrantor trusts are required to disclose and report distributions for the year of receipt. Depending on the nature of the underlying assets of the trust and the frequency of distributions, US beneficiaries may face significant obligations with respect to income tax on — and the reporting of — distributions received. Therefore, US taxpayers who establish foreign trusts or are beneficiaries of those trusts should work closely with their advisors to report properly any interest in, transfers to, or distributions from a foreign trust and pay any US tax that may be due on the distribution received. Bequests from a foreign estate are generally not taxable (see the exception discussed in the expatriation section later in this chapter) but may require disclosure.

### **Transfers of property to foreign entities and trusts**

In addition to having to report various transactions involving foreign entities and trusts, US taxpayers may unknowingly subject themselves to tax on transfers that would otherwise be tax-free in the domestic context. Transfers of appreciated property by US

taxpayers to domestic corporations and trusts generally do not result in the recognition of gain for income tax purposes. The rules, however, do not necessarily extend to transfers to foreign corporations and trusts. Transfers of appreciated property to certain foreign corporations usually result in the recognition of gain for income tax purposes. Similarly, gifts of appreciated property by US taxpayers to certain foreign trusts may result in the recognition of gain.

### **The global shift toward transparency Global efforts**

In recent years, concerns about terrorism funding and tax fraud have prompted governments around the world to put unprecedented focus on cracking down on money laundering and tax evasion. The United States is at the forefront of these efforts, putting particular emphasis on identifying assets held offshore, such as in tax havens. The United States has entered into many bilateral agreements with foreign governments, most notably with Switzerland, as a way to unearth previously undisclosed foreign assets of US taxpayers.

### **FATCA**

One of the most important domestic efforts to tackle these issues took shape in March 2010 when the Hiring Incentives to Restore Employment Act (HIRE) was enacted. Included in the HIRE Act is the Foreign Account Tax Compliance Act (FATCA). FATCA is an important development in the US government's efforts to combat tax evasion, as it is intended to increase the ability of the IRS to detect US taxpayers who are using foreign accounts and investments to avoid US taxation and disclosure.

Under FATCA, every foreign financial institution (FFI) is required to enter into disclosure agreements with the IRS. If an FFI does not enter into an agreement, then all relevant US-sourced payments will be subject to a 30% withholding tax. FATCA also implements a new reporting requirement for owners of specified foreign financial assets. The size of the US economy and the number of US investors means that FATCA cannot be ignored.

### Voluntary disclosure

Recognizing that a substantial number of US taxpayers with offshore assets were most likely not in full compliance with their filing responsibilities, the IRS decided to take steps that would encourage greater compliance. In 2009, the agency introduced the Offshore Voluntary Disclosure Initiative (OVDI) whereby noncompliant US taxpayers could voluntarily disclose unreported income from foreign accounts and investments in exchange for reduced penalties and avoidance of criminal prosecution.

OVDI resulted in significant revenue generated from back taxes, interest, and reduced penalties. The IRS therefore proceeded to roll out another OVDI, in 2011, but with higher penalties than those under the 2009 program.

The latest OVDI is based on the 2011 program, requiring taxpayers to file original or amended returns for a number of years and pay all back taxes, as well as penalties and interest for delinquency and insufficient accuracy. The current OVDI program does not have an end date, unlike its two predecessors.

The IRS has indicated a willingness to soften its stance toward taxpayers who have reasonable cause for noncompliance or who have paid all taxes due but haven't met their reporting requirements. This may encourage taxpayers with more-straightforward issues to come forward and become compliant.

### Foreign information reporting

#### *Report of Foreign Bank and Financial Accounts*

One of the most typical offshore assets owned by individuals is a foreign bank account. US taxpayers who have a financial interest in or signatory authority over certain foreign financial accounts must file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR).

In filing this report, a person is not required to pay any tax (the income amounts are included on the person's individual income tax return), but the filer does have to report on an annual basis the maximum balance for each account (if the aggregate balance is greater than \$10,000). The definition of a foreign "account" for purposes of this report is very broad, and many investments that might not seem as though they need to be disclosed do in fact have to be reported. The report is due June 30, with no extensions permitted. Failure to file can result in significant penalties.

#### *Foreign asset disclosure*

With the enactment of FATCA in 2011, US taxpayers have been under the annual requirement to report their interests in specified foreign financial assets. A US taxpayer who meets certain requirements must disclose any such assets on Form 8938, *Statement of Specified Foreign Financial Assets*. The form is filed with a taxpayer's US income tax return.

The assets disclosed on Form 8938 may include stocks or securities issued by a non-US taxpayer, any interest in a foreign entity, and any financial instrument or contract that has a non-US issuer.

While the FBAR and Form 8938 may contain some of the same information, they are two separate filings. The penalty for failing to file or accurately report the information required for Form 8938 is a minimum of \$10,000 and can be a maximum of \$50,000.

## **Estate, gift and generation-skipping transfer tax considerations**

### **US citizens and US tax residents**

The United States taxes its citizens and certain US residents on transfers of wealth during life and at death. Similar to the US taxation of worldwide income, taxation on the transfer of US citizens' and certain US residents' worldwide property occurs regardless of the location of the property or its owner. Therefore, potentially all transfers of wealth are subject to US estate tax, gift tax, and generation-skipping transfer tax (collectively known as "transfer taxes").\*

For US citizens, the reach of the US transfer tax system is fairly clear. The rules for noncitizens, however, are more complex. As discussed earlier, residency for US income tax purposes is based on objective tests (permanent residence status and substantial presence). The residency test for US transfer tax purposes is subjective, although it is based on an individual's domicile and therefore is mainly a question of fact.

An individual will be considered domiciled in the United States if he or she is living there and intends to stay indefinitely. When assessing an individual's intent to remain permanently in the United States, courts may consider a variety of factors, including place of residence and business (and duration); the location and extent of social and community contacts; existence of a green card or visa; and so forth. Individuals residing in the United States for employment or education purposes while maintaining close

connections to their home country generally will not be considered residents for purposes of US transfer tax. On the other hand, individuals who have obtained permanent resident status (holders of green cards) are more likely to be considered domiciled in the United States for US transfer tax purposes.

### **Nonresidents and US situs**

Nonresidents are subject to US transfer taxes on property located in the United States. The definition of *US situs* property for purposes of estate and gift tax varies slightly, depending on the context. For estate tax purposes, US situs property includes real and tangible property located in the United States, stock issued by US corporations, certain obligations of US taxpayers, deferred compensation and pensions paid by US taxpayers, and annuity contracts enforceable against US obligors. Notably absent from the list, and consistent with US policy that encourages foreign investment, are US bank deposits and US Treasury bonds.

This is in contrast to the US gift tax, which is imposed on nonresidents' gifts of real and tangible (but not intangible) property situated in the United States if the value exceeds \$14,000 per donee per year (or \$143,000, in the case of gifts given to a non-US-citizen spouse in 2013). Unlike US citizens and residents, nonresidents are not entitled to a lifetime gift tax exemption. However, for purposes of US gift tax, a reduced estate tax exemption is available for the value of US situs assets that exceed \$60,000.

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\* Please see chapter 4, "Estate and Gift Planning," for an in-depth discussion of the US estate and gift tax system.

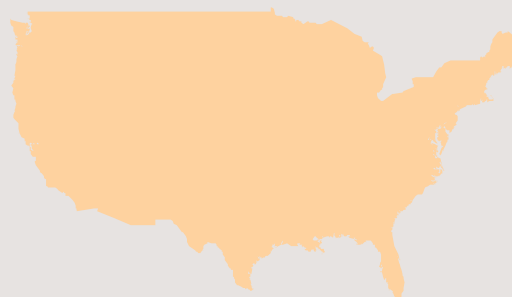
## Residency test

### What makes a person a US resident for purposes of the US transfer tax?

The residency test for purposes of the US transfer tax is subjective. That said, a determination of US residency is based on an individual's domicile. Therefore, residency is mainly a question of fact.

An individual will be considered domiciled in the United States if the person is living there and intends to stay indefinitely.

When assessing an individual's intent to remain permanently in the United States, courts may consider a variety of factors.\*



#### Place of residence/ business (and duration)



#### Location and extent of social/community contacts



#### Existence of a green card or visa



Individuals who have obtained permanent resident status — holders of green cards — have a good likelihood of being considered domiciled in the United States for purposes of US transfer tax.

Generally, individuals residing in the United States for employment or education purposes while maintaining close connections to their home country won't be considered residents for purposes of US transfer tax.

\* This infographic notes just a few of the factors a court might consider in determining residency status.

## *There is an unlimited marital deduction for amounts transferred to a US-citizen spouse.*

Note that a nonresident's transfer of stock that was issued by a US corporation is not subject to US gift tax but is subject to US estate tax if the stock is owned by the nonresident at the time of his or her death. Another consideration that is very relevant for nonresidents is the US gift and estate taxation of US real property, which is discussed at the end of this chapter.

### **The noncitizen spouse and the marital deduction**

The noncitizen spouse presents special considerations in estate planning. As discussed in chapter 4 of this guide, providing for the surviving spouse is often among the primary goals in estate planning. To that end, there is an unlimited marital deduction for amounts transferred to a spouse, as long as the receiving spouse is a US citizen.

The unlimited marital deduction does not apply to transfers to noncitizen spouses, including spouses holding green cards. This rule was implemented because of concern that upon the death of a US-citizen spouse, a noncitizen spouse might move to another country and thus avoid US gift and estate tax on future transfers. In the latter situation, the unlimited marital deduction is replaced with a “supersized” gift tax annual exclusion (currently \$143,000 for transfers in 2013). For estate tax purposes, the marital deduction is denied unless the property is placed in a qualified domestic trust.

### **QDOTs**

Although the unlimited marital deduction is not available for outright transfers to a noncitizen spouse, an unlimited marital deduction may be obtained if the property is passed to a qualified domestic trust (QDOT). A QDOT is the only non-treaty way to claim a marital deduction on assets passing to a noncitizen spouse upon the death of the US-citizen spouse. The terms of the trust, however, must meet certain criteria, including the requirements that the trust have a US trustee, that US estate tax will be paid on distributions of principal to the surviving noncitizen spouse, and that the assets remaining in the trust will be subject to US estate tax upon the death of the noncitizen surviving spouse.

While QDOTs can be created after death to ensure that the estate is handled properly and according to the decedent's wishes, it is recommended that QDOT provisions be incorporated into estate planning documents. In addition to a QDOT, a program to take advantage of the larger gift tax annual exclusion for transfers to a noncitizen spouse should be considered for transferring assets outright to a noncitizen spouse. Another available option is for a surviving spouse to become a US citizen within a certain period following the death of the US-citizen spouse.

Certain tax treaties (e.g., with Canada, France, and Germany) contain provisions that provide relief from the US estate tax for assets passing to a noncitizen spouse in the form of a “marital credit.” However, this credit is limited, and it is in lieu of any marital deduction that would otherwise be available with a QDOT.

## Forced heirship and community property

An issue that's often overlooked in planning is the impact that forced heirship and community property laws may have on an individual's ability to dispose of his or her property freely. Common law jurisdictions (such as most states in the United States) generally allow individuals to transfer property to whomever they desire, including in trust.

In contrast, civil law countries usually limit an individual's ability to transfer property freely through community property and forced heirship laws. In particular, forced heirship laws may require a decedent to leave some part of his or her estate directly to his or her children, at the expense of a surviving spouse, potentially frustrating the surviving spouse's ability to claim a marital deduction for US estate tax purposes. For families with property overseas, it is important to work with advisors who understand how laws in different jurisdictions may impact their estate planning.

## Estate and gift tax treaties

Further complicating the planning process (but designed to provide clarity and, oftentimes, relief from the complexities involved in cross-border estate planning) are tax treaties between the United States and many countries. Currently, the United States has a number of estate tax treaties in effect with different countries, providing rules that may mitigate the applicability and impact of the general rules that apply to the US estate tax of nonresidents. To a lesser extent, there are also treaties that deal with US gift tax.

## Charitable contributions

The US tax system has long allowed US taxpayers to reduce their income, estate, and gift tax liability with deductions for gifts to certain charitable organizations. The elements of a deductible charitable contribution are generally the same for purposes of both income tax and transfer tax. There are, however, several significant differences.\*

The most notable difference is that gifts to certain foreign qualified charitable organizations that are not deductible for purposes of US income tax generally are deductible for purposes of US estate and gift tax. While this difference might not impact US citizens, the impact on US residents who maintain connections with their home country and who are charitably inclined should be considered.

Another notable difference between the income tax charitable deduction and the transfer tax charitable deduction is that the charitable deduction for income tax purposes has a percentage limitation imposed on it, whereas the charitable deduction for estate and gift tax purposes has no percentage limitations. Also, the amount of the deduction does not differ based on the type of charitable organization or the type of property contributed (for example, a public charity versus a private foundation).

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\* Please see chapter 3, "Charitable Giving," for a more in-depth discussion of the rules for charitable giving and the related tax considerations.

## *US citizens and permanent residents who are considering expatriation should carefully review the titling and basis of their assets.*

### **Special considerations**

#### **Coming to America**

Proper planning and structuring before establishing US residency can reduce or eliminate paying unnecessary US tax and can simplify future US tax reporting and compliance. Likewise, estate plans should be reviewed to consider the merits of structuring estates in a way that takes into account foreign assets and non-US heirs. As noted earlier in this chapter, the interplay between different countries' rules with regard to inheritance can be complicated, meaning that taxpayers should make sure their plans are regularly reviewed and updated by advisors in the relevant jurisdictions.

#### **Leaving the United States**

##### *Expatriation*

In June 2008, the United States introduced a new taxation regime for certain individuals who give up their US citizenship or relinquish their green cards. The new law imposes an exit tax on the worldwide assets of these "covered expatriates."

Although there are certain exemptions, the new law applies to certain US citizens and US long-term residents who meet specified income and net-worth tests.

A new, separate inheritance tax is also imposed on US citizens or residents who receive gifts or bequests from covered expatriates. If, for example, someone expatriates and leaves behind US-citizen children, the impact of this tax needs to be carefully considered.

Individuals who are thinking of acquiring a green card or applying for US citizenship should consider how the exit tax and inheritance tax could impact them if their plans to remain in the United States were to change. On the other hand, US citizens and permanent residents who are considering expatriation should carefully review the titling and basis of their assets (as well as other planning opportunities that might be available) before taking any action. For those considering a move, the current environment of depressed asset values across many markets may make this a good time to proceed.

#### **Nonresident tax considerations**

As noted earlier in this chapter, nonresidents have some flexibility in the structuring of their US holdings.

##### *Real estate*

US real estate is US situs property. Consequently, the United States will always have the primary taxing right over such property per the income, gift, and estate tax rules. There may be planning opportunities to alleviate the estate tax bite, but any potential estate tax benefit must take into account possible adverse income tax consequences.

##### *US equities*

While dividend payments from US corporations paid to nonresidents are subject to US tax withholding at varying rates, depending on whether or not a treaty is in place, sales of such equities are not typically subject to capital gains. Such assets, however, are considered US situs property for estate tax purposes and therefore consideration should be given to planning for the estate tax.



### *Alternative investments*

For many nonresidents, it makes sense to hold alternative investments such as hedge funds through a corporate entity established outside the United States. These are commonly known as offshore “feeder” funds. Most hedge funds make this option available to non-US residents. Entering the fund through an offshore feeder will simplify US tax reporting for the nonresident investor. US citizens or permanent residents living outside the United States, however, should double-check that they have not inadvertently invested through the offshore feeder, as this can create unwanted PFIC\* issues.

### *Conclusion*

As world markets become increasingly intertwined and the global reach of families widens, taxpayers will need to be ever more aware of cross-border considerations in their tax planning. Complex rules, additional disclosure requirements, and stricter penalties make timely, qualified advice and proper planning essential. This is especially important in the current environment, where focus on the disclosure, reporting, and taxation of foreign assets has sharpened and may only intensify in coming years.

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\* Passive foreign investment company

A woman with blonde hair, wearing a white cardigan over a dark top and patterned pants, sits on a brown leather sofa. She is looking intently at a laptop screen held by a man whose back is to the camera. The man is wearing a grey suit jacket and a white shirt. On the coffee table in front of them is a glass of water and some papers. The background features a white wall with two abstract, textured artworks.

# *Risk management*



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**Ch9** Protecting your property and other assets from various risks involves more than just obtaining adequate insurance coverage.

In recent years, local and global headlines have taught us to expect the unexpected. While many of us are unlikely to experience a sizable risk event that has direct consequences for us personally, we're nonetheless wise to take protective measures — especially since a low-probability event can be just as impactful as an easily anticipated one. Guarding against both eventualities is the purpose of sound risk management. A well-considered and routinely reviewed plan should help ensure that your family's health and wealth are protected for the long term.

**Asset ownership**

Protecting your property and other assets from various risks involves more than just obtaining adequate insurance coverage. It also entails making strategic decisions about forms of asset ownership. How you own your assets can be a determining factor in whether they are at risk or are safe.

Choosing the right form of asset ownership is important for several reasons:

- Protection from creditors (liability protection)
- Protection from the probate process upon death (court-supervised asset distribution)
- Protection from estate taxes either now or later (certain types of trusts can protect assets from estate taxes through multiple generations)

## Trusts are especially helpful in protecting assets.

The actual level of protection is a function of state law (which varies significantly across jurisdictions). It is up to you, however, to determine which form of asset ownership is most appropriate in your circumstances. Some forms offer considerably more protection than others.

### Assets held in joint name with a spouse

Assets held in joint name with a spouse (with rights of survivorship) are thought to have a slight degree of liability protection and certainly are protected from the probate process. However, jointly held assets are often quite problematic for estate-planning purposes, since they pass directly to the survivor and do not flow into estate-tax savings trusts. Joint property bypasses any estate planning and can create difficulties if there aren't enough assets to fund a credit trust. When there is too much joint property, or only joint property, the result may be that the estate-tax savings trusts created in testamentary documents cannot be funded. However, this has been less of an issue since estate tax rules underwent certain changes in 2010.\*

Assets held in *joint name* with others remain in the estate of the original owner (i.e., are not removed from the estate for tax purposes) but do not go through the probate process. Assets held as *tenants in common* (with each person owning an undivided interest in the asset) are subject to the probate process and do not provide any asset protection. The account may be entitled to a discount in value upon an asset-holder's death, and it can flow into estate-tax savings trusts.

### Revocable and irrevocable trusts

Trusts are especially helpful in protecting assets. Assets held in the name of a revocable trust (or living trust) have no special liability protection, but they are protected from the probate process and can flow into estate-tax savings arrangements upon death. Assets transferred to irrevocable trusts, on the other hand, do provide liability protection, do not go through the probate process, and can provide significant estate-tax savings. However, irrevocable trusts involve issues regarding gift tax and generation-skipping tax, as assets are transferred into them. Irrevocable trusts created by someone else for your benefit have significant advantages (liability protection, probate avoidance, and estate-tax protection).

### Self-settled asset protection trusts

Some states provide liability protection for self-settled asset protection trusts — also called domestic asset protection trusts. These are trusts that you create for yourself and your family (i.e., you are a beneficiary, along with your family, hence the term *self-settled*). The purpose is for the assets to be available to you (e.g., for living expenses) but not available to creditors. When it comes to probate protection, these trusts are much like revocable trusts but with the added liability protection that's normally associated with trusts created by others. There is some disagreement in the legal community about the exact amount of liability protection such trusts offer (i.e., whether creditors can gain access to the assets). The states usually require the use of an in-state institutional trustee for full protection. Further, recent changes to US bankruptcy law require a waiting period for the asset-protection features.

\* In 2010, a new provision was added to the estate tax rules, one that allows portability of the federal estate tax exemptions between spouses — the executor of a deceased spouse's estate is permitted to transfer any unused estate tax exemption to the surviving spouse.

## *Some forms of asset ownership offer considerably more protection than others.*

The 15 states permitting self-settled asset protection trusts are Alaska, Colorado, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming.

### **Offshore asset protection trusts**

Domestic asset protection trusts have reduced the popularity of offshore asset protection trusts. Offshore asset protection trusts are self-settled trusts created in another country (for example, Bermuda or the Cayman Islands). There are multiple professional groups that specialize in advising people on where to set up these trusts and how to structure them. Such arrangements come with various complications and fees. As with domestic asset protection trusts, the degree to which these offshore versions truly protect assets is a subject of debate in the legal community.

Offshore trusts come with a host of special tax filing requirements. These requirements are imposed on the trustee, beneficiary, or trust creator. Beginning with the 2011 individual income tax return, specified individuals (these include US citizens, resident aliens, and certain nonresident aliens) have had to be alert to their potential need to file Form 8938, *Statement of Specified Foreign Financial Assets*, as part of their normal income tax return. This filing is in addition to any filing obligation related to Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). Duplicate information may be required on both forms. There is a higher filing threshold associated with Form 8938 (i.e., a higher dollar-amount threshold), along with significant penalties for noncompliance.

### **Limited liability company or limited partnership**

Assets held in the name of a limited liability company (LLC) or limited partnership (LP) also provide significant risk-management advantages. While the LLC/LP ownership interests can be transferred, the assets within the LLC/LP are generally considered free from forced sale. The traditional view is that LLC/LP interests are not attractive assets for creditors (including divorcing spouses). Combining the LLC/LP with an irrevocable trust is considered a double form of asset protection and is quite popular with financial advisors.

### **Insurance protection**

A fundamental form of asset protection is insurance. Key types of insurance include:

- Property and casualty
- Liability
- Medical
- Disability
- Long-term care
- Life

In shopping for new insurance or reviewing current coverage, you may want to assess the financial strength of your insurance carrier, rather than take for granted any particular insurer's ability to pay claims. Other considerations regarding particular types of insurance are discussed on the following pages.



## Property and casualty insurance

Property and casualty insurance includes homeowner'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 coverage options. Recent natural disasters underscore the importance of understanding what various insurance options cover and do not cover.

It's also important to investigate whether one policy cancels out or overlaps another one, since you'll want to consider cancelling redundant coverage. You'll also want to make sure that your property and casualty insurance policies cover all of your jewelry, artwork, and other collectibles. If you obtain combined coverage from one carrier, you may be eligible for a discount.

## Liability insurance

Because large judgments are sometimes awarded for injuries, an umbrella policy may be worth considering. An umbrella policy provides liability coverage in addition to regular homeowner's or auto insurance. You should consider purchasing the maximum amount of coverage (premiums are relatively low). Be sure to coordinate your umbrella policy with base levels of liability coverage under your homeowner's, auto, and boat policies so that you don't inadvertently overlook gaps in your total coverage.

For airplane coverage, the key considerations are the ownership and use of the plane. Special Federal Aviation Administration (FAA) rules apply to airplane use. The liability coverage

associated with airplanes is often linked to specific planned use, as defined by the FAA. Be especially careful when insuring aircraft used for mixed purposes — partly for business and partly for personal activities. Also realize that coverage eligibility depends on which person or entity owns the aircraft and who is doing the actual flying. While placing ownership of an aircraft in a limited liability company can offer certain advantages, it can also significantly alter or invalidate liability coverage.

## Medical insurance

Healthcare costs continue to rise, along with the premiums many people have to pay for health insurance (under federal law, most people will be required to have some level of coverage, beginning in 2014). You should make sure you have the health insurance that best fits your needs. Increasingly, individuals are making greater contributions toward their medical costs, including contributions to high-deductible plans that are designed to cover catastrophic medical events. When choosing among different forms of coverage, keep in mind certain tax-favored, optional health-plan features:

### Flexible spending account (FSA)

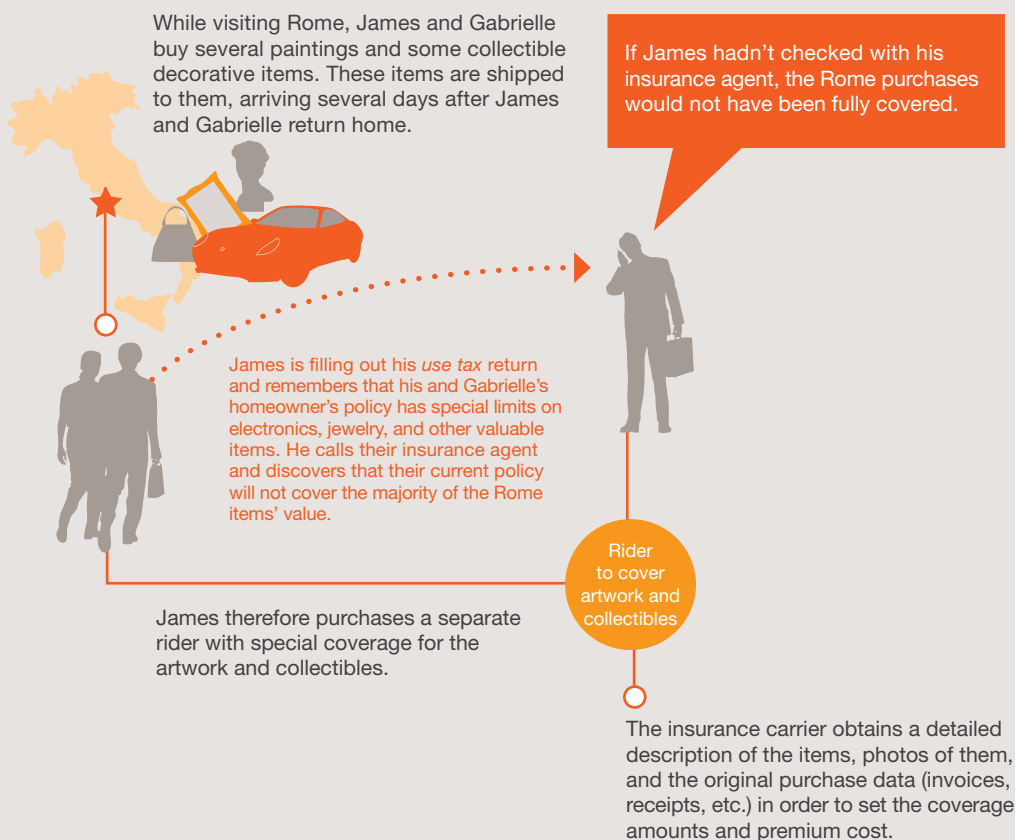
This is an employer-sponsored savings arrangement for medical costs. Under an FSA, allowable medical costs are reimbursed from a notional account that includes employer flexible spending credits and amounts withheld from an employee's wages, as elected by the employee. The advantage of an FSA is that the contributions are made on a pretax basis. The disadvantage is that if you do not spend all of the funds that you've set aside, they revert to your employer. In other words, "use it or lose it."<sup>\*</sup>

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<sup>\*</sup> The IRS is considering repealing the "use it or lose it" rule.

## Safeguarding your souvenirs

When bringing home more than just trinkets from your travels, make sure your homeowner's insurance covers their value





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. Bear in mind that the Affordable Care Act eliminates the ability to use funds for over-the-counter drugs (such as aspirin). As of 2013, the maximum amount that can be set aside in an FSA is \$2,500 (this amount is to be indexed annually for inflation). FSAs 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 are tax deductible. Both employers and employees can make contributions to the account (subject to an annual limit). Income tax does not apply to distributions from an HSA, as long as they're used for medical expenses. For HSA distributions that are not applied to qualified medical expenses, there is a 20% tax penalty.

Because an HSA can continue for long periods, the best strategy is to leave it alone as long as possible, paying current medical expenses with other funds. This allows the account to accumulate earnings, tax free, which can be used later in life (after retirement). Health savings accounts are available to partners in partnerships and to shareholders in S corporations.

When taking the long view, bear in mind that if you have a high-cost (“Cadillac”) healthcare plan, your employer may have to pay a 40% excise tax, starting in 2018, if the aggregate value of the coverage for a participant is over a certain amount: \$10,200 for individual coverage and \$27,500 for family coverage. Employers may choose to revise their high-cost plans by 2018 or else possibly pass on the cost of the excise tax to employees, in the form of higher contributions.

### 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 a disability, the level of coverage, cost-of-living adjustments, waiting periods, and earnings caps.

Disability benefits are taxable if an employer either deducts or pays for the insurance premiums. Income tax does not apply to disability benefits 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 else they should make sure the premiums are included in their wages, to minimize the tax impact of any benefits received.

It's important that the definition of a 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 to benefit payments increases the premium.

### Long-term-care insurance

Medicare generally does not pay the nonmedical costs of retirement homes, custodial care, or 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, in part because it involves protecting assets for children and grandchildren. While long-term-care insurance is generally not recommended for those of high net worth (who can self-insure), it is a prudent choice for individuals of moderate wealth.

## *Life insurance is particularly important for purposes of estate tax planning.*

### **Life insurance**

Life insurance is an important component of an individual's overall financial plan. It is particularly important for purposes of estate tax planning. Amount of coverage, ownership of policy, and designated beneficiary are all factors a person should take into careful consideration when choosing a plan. The remainder of this chapter discusses these and other important points to keep in mind as you contemplate your life insurance options.

### **Life insurance decision factors**

The market offers a wide variety of life insurance products. Insurance carriers continually add, delete, and change policy features to meet the demands of a competitive market. Further, it may be difficult to find a comprehensive, stable source of information about how life insurance policies compare with one another, the investment performance of each, or fee structures (whereas there are such information sources for researching mutual funds). The following questions should help you narrow your search:

- *What is the purpose of having the insurance?* Is it to insure the family breadwinner? Pay off debts upon death? Pay estate taxes? Fund an inheritance? Obtain protection in transitioning a business? Or, rather, is the insurance a form of investment?
- *How long do you need the insurance?* Is it meant to provide a level of security only until your children reach adulthood? If you're a business owner, are you intending to hold the life insurance only until a liquidity event occurs? Or is the policy meant to last throughout your life and be used to pay estate taxes?

- *How much insurance do you need?* Have you calculated what your family or other beneficiaries 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?
- *Who should be insured?* Is it the main breadwinner? Both husband and wife? The whole family, including grandchildren? The business owner(s)?
- *Who should own the insurance?* It's typically not the insured party, 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 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 a life insurance trust is in place.

Determining the answers to these questions will help you carefully structure the ownership and beneficiary designations of your life insurance policies so that you limit or eliminate the impact of income tax, gift tax, and estate tax.

### Trends in life insurance policy choice

People seeking temporary life insurance most often find that their needs are met via *level-premium term insurance*. With that type of policy, you pay the same amount for a set number of years (five to twenty years, depending on your 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).

The need for longer-term life insurance used to be met by *whole life insurance*, which is a type of permanent life insurance that guarantees lifelong protection as long as you pay the premiums. This type of coverage is very predictable but inflexible. *Universal life insurance* — which is permanent life insurance but with fewer guaranteed features — became popular in the 1980s and 1990s (a period of relatively high interest rates) because agents could engineer policy returns to illustrate lower premiums. 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, agents could engineer policy returns based on robust stock market returns, thus showing reduced premiums. Many universal life and whole life policies were surrendered in exchange for variable life coverage. With the major market declines in the period spanning 2001 to 2003, and again in 2008, the variable policy lost its popularity.

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

***When you choose life insurance carriers, diversification is important. The best or safest carrier today might not be the best or safest carrier 20 or 30 years from now.***

*Second-to-die insurance* (also known as survivorship insurance or joint life insurance) pays a benefit upon the death of the second of two jointly 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.

### Life insurance diversification

Life insurance is an insurance carrier's promise to pay. That promise is only as strong as the carrier. When you choose life insurance carriers, diversification is important, just as in any other investment. Large amounts of death benefits should be placed with a variety of carriers, since the best or safest carrier today might 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 rate insurance companies; those ratings can be helpful in selecting insurance carriers with financial strength and stability.

### Life insurance strategies

#### *Insuring the breadwinner*

The most common use of life insurance is to provide, upon the death of the insured, cash for the care of surviving family members. The death proceeds can be set aside either in income-producing investments (which will serve as a substitute for the breadwinner's wages) or for paying off debt obligations such as mortgages. Today, families often have more than one breadwinner and may therefore need a life insurance program that provides coverage for several breadwinners, based on their individual earnings level and insurability.

Traditional single-life products are more appropriate than second-to-die products for families that want the life insurance proceeds to be available upon the death of the breadwinner. The most cost-effective product is usually *level-premium term insurance*. However, keep in mind that no simple formula (such as a multiple of salary) can determine how much life insurance you need. Rather, you should consider many factors, including liquidity needs, the earning power of surviving family members, projected expenses, family involvement and financial 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 fulltime 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.

#### *Paying estate taxes*

Estate tax can be a heavy financial burden for a family, particularly if the estate includes closely held stock or other illiquid assets. Using life insurance proceeds to provide cash for estate tax payment can be an effective planning strategy, sparing the family the necessity of selling assets at fire-sale prices.

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

## *Key-person insurance provides funds for continuing a business after the death of a key employee.*

Under current federal estate tax laws, most state estate tax regimes, and most professionally prepared estate planning arrangements, 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 provide a payout until the death of the survivor. As noted earlier, this type of insurance is known as second-to-die insurance, or survivorship life insurance.

Determining the amount of coverage is not as easy as simply calculating estate taxes based on current assets. Instead, the following factors should be considered as well:

- Target premium level
- Target inheritance level
- Current asset mix
- Future asset mix
- Gift strategies with trusts

As mentioned earlier, a very popular form of survivorship insurance is a universal product with secondary guarantees. Coverage is guaranteed regardless of changes in interest rates, as long as you make premium payments on time. The cost of coverage can be compared easily among carriers.

### *Meeting the needs of businesses and their owners*

Business owners use life insurance for many reasons. For instance, they may want to ensure that they can do the following:

- Continue operations after the loss of a key employee
- Provide survivor income for the family
- Provide liquid assets for estate taxes
- Provide an equalizing inheritance for children not involved in the business
- Fund buy-sell arrangements such as redemption or cross-purchase agreements

In contemplating each of these options, business owners may want to keep the following considerations in mind:

- **Continuing operations after loss of a key employee:** Key-person insurance provides 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 for the deceased employee (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. In the case of another employee replacing the insured key employee, many carriers will retain the existing policy (by having it substitute the new employee for the prior employee) rather than issue a new policy; however, such substitution usually has income tax consequences.

## *Most businesses, though quite valuable, can be illiquid in the hands of the estate administrator.*

- **Providing survivor income, liquid assets for estate taxes, and an equalizing inheritance:**

If the business owner is also the family's sole wage earner, the survivors may encounter problems obtaining funds from the business, due to technical corporate income tax rules. Therefore, many business owners purchase life insurance to provide a temporary source of funds for surviving family members until the business's future is settled.

Most businesses, although quite valuable, can be illiquid in the hands of the estate administrator, whereas life insurance is liquid upon the death of the insured. Business owners often purchase life insurance to pay estate taxes, especially when the family wants to hold on to the business.

Finally, insurance can provide a separate inheritance for those children who will not share 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 then rely on life insurance to provide for the children who will not be running the family business. This can be an effective way to avoid an arrangement in which some of the children acquire ownership in the business as absentee investors — a situation that sometimes leads to family conflicts.

- **Funding for redemption agreements (sometimes known as buy-sell agreements):**

Life insurance for a business transition should be arranged in a tax-efficient manner. Changes in owner or beneficiary can produce radically different tax results. This is especially true with buy-sell agreements.

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

- **Avoiding corporate redemption arrangements:** A corporate redemption (buy-sell agreement) funded by corporate-owned life insurance is not a tax-efficient way to transfer ownership upon death. There are several reasons for this:
  - ▶ Distortion of the business value, because the insurance death benefit can be added to the value of the business for purposes of estate tax
  - ▶ 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



## The easy way doesn't always pay

An insurance solution that saves you time might end up costing you in taxes. Here's how one business owner found out the hard way.

Steven and Taylor run a successful business with two other partners. After Steven's neighbor dies unexpectedly from a heart attack, it occurs to Steven that if the same were to happen to him or one of his partners, the business could be at risk. He raises this issue with his partners and they decide to call a meeting with the business's attorney, insurance agent, and accountant to discuss protective measures.



The attorney suggests a buy-sell arrangement whereby the business purchases the stock of an owner once that person leaves the company or passes away.



The insurance agent nods his head and points out that under such an arrangement the company would be both the owner and beneficiary of the policy.

The accountant points out that the premiums would be a nondeductible expense for tax purposes and that the policy's cash value would be an asset of the business.

When Taylor passes away three years later, the company receives \$5,000,000 of death benefits. After an appraisal, Taylor's stock is valued at \$9,000,000, and the company buys the stock from Taylor's widow.

The estate is audited. As a result of the audit, the value of the stock is increased by \$1,250,000 (Taylor's share of the life insurance), and Taylor's widow must pay \$500,000 of additional estate tax.

A dozen years later, Steven decides to quit the business and sells his shares for \$8,000,000. He asks the accountant to calculate his gain on the sale. The accountant points out that Steven's basis in the company is \$2,000,000, which didn't change when the company bought out Taylor's shares.

Partners call a meeting

3 years later...  
Taylor passes away

A dozen years later...  
Steven quits the business

Steven's  
basis in the  
company is  
\$2 million



Steven realizes that the seemingly quick and easy redemption done with Taylor's widow has created a chain of unfortunate tax events. If he and the other two surviving partners had purchased Taylor's shares from his widow directly (a cross-purchase arrangement) she wouldn't have had the \$500,000 estate tax issue, and Steven's basis in the company might have been \$750,000 greater.

Despite these tax issues, the redemption buy-sell arrangement is a common form of dealing with the death of a business owner — probably because it's the easiest arrangement to put in place.

- **Funding cross-purchase agreements:** A more tax-efficient (and flexible) arrangement than the traditional redemption 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 a party to the agreement.

The owners of the business purchase life insurance on one another's lives. Only one policy per owner's life is needed (multiple policies are not required). The owners create a special partnership to purchase and hold the life insurance. The partnership is the owner and beneficiary of the policies and makes all premium payments. Upon the death of a shareholder, the partnership distributes the cash among 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 these arrangements generally continue for a long time), such as whole life, universal life, and variable life insurance.

#### *Funding nonqualified deferred compensation arrangements*

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

Congress more than once has changed the income tax treatment of life insurance policies owned by corporations (especially treatment of 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 they are not deductible for income tax purposes. New tax laws require that companies obtain an executive's permission before purchasing the policy, and then provide the IRS with information on the policy when the business files its annual tax return. Policies on individuals who are not executives or employees at the time of their 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 pays those benefits out of its current cash flow. The employer has the option to borrow from the policies 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 exempt from income tax, 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 a company, due to the mismatch in cash flow payments: Premium payments and executive benefit payments are cash outflows in the early years, while death benefit payments are cash inflows much later. 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.

### *Life insurance as an investment*

Life insurance is really an investment for the next generation. The after-tax investment return on life insurance sometimes compares favorably with that on other asset classes (of course, the investment return of life insurance has a major variable — the death of the insured).

Investment professionals have nonetheless become attracted to life insurance, since the investment returns do not seem to be correlated with traditional asset classes. This is because the investment return is based on an insurance carrier's estimate of future investment returns from the carrier's portfolio, mortality rates, and administrative expenses. The investment return is engineered by the carrier's assumptions and depends on the carrier's promise to pay. The goal of this strategy is to produce an acceptable after-tax rate of return upon death via the insurance carrier's general investment returns.

An alternative strategy is to take advantage of the favorable income tax treatment of a policy's cash-value growth by deliberately placing certain investments within the policy. Here the goal is to defer or eliminate the annual income tax consequences associated with the investment.

In these cases, the policy itself is being used as an investment wrapper. The economic decision a person should weigh here is whether the mortality and administration charges associated with the policy are less than the income tax cost of the investment returns absent the policy wrapper. With increases in income tax rates, this may become a more popular investment alternative.

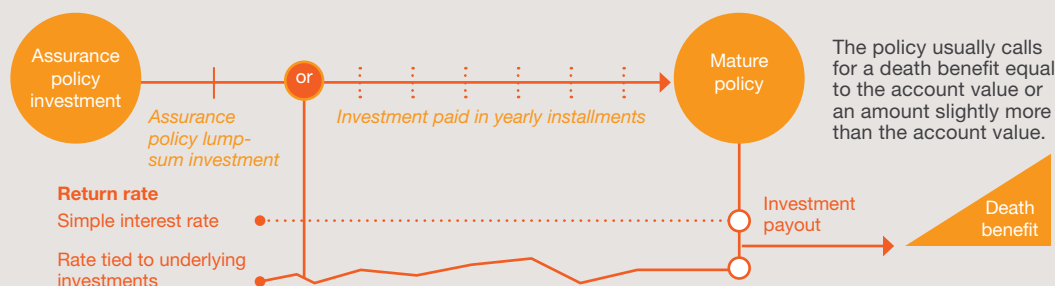
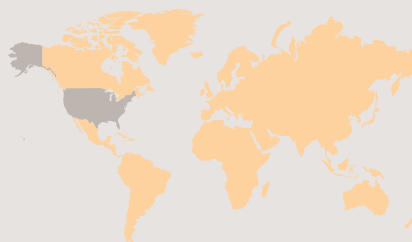
## Foreign life products as an investment

### Compelling but not clear-cut

A popular investment outside the United States is something called a life assurance policy.\* Upon purchasing such a policy, the buyer is promised a rate of return by the insurance carrier.

The investment may be made in a single sum or in installments over a period of years. The rate of return can be a simple interest rate or can be tied to the performance of an underlying basket of investments.

When the policy matures, the funds are paid out based on the performance of the chosen basket of investments or interest rate.



#### What's clear

Life assurance policies are required to be reported annually on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*. They must also be reported on Form 8938, *Statement of Specified Foreign Financial Assets* (when the dollar amount exceeds the filing thresholds).

A life assurance policy is unlikely to be treated as a passive foreign investment company (PFIC),\*\* because the investor doesn't actually own the underlying investments but simply is promised an investment return based on the basket of investments.

Life assurance policies typically have attractive income tax features that apply in the country of origin (income tax deferral or reduced tax rates). Some arrangements also provide important estate tax savings in the country of origin. However, life assurance policies also tend to have significant fees and expenses associated with them, and it can be difficult to obtain data on historical investment performance.

#### What's not clear

The US income tax treatment of life assurance policies isn't entirely clear. Usually the policies do not qualify as life insurance under the strict US tax definition. This would suggest that a life assurance policy's earnings are subject to income tax each year, since they are credited to the policy.

Another theory is that life assurance policies tied to underlying baskets of investments resemble some types of US financial instruments that are taxable only upon termination/settlement.

\* This type of policy cannot be sold in the United States (due to requirements relating to securities and insurance registration and regulation). It is advisable to consult a tax advisor when considering such policies.

\*\* PFICs include foreign-based mutual funds, partnerships, and other pooled investment vehicles that have at least one US shareholder. Most investors in PFICs must pay income tax on all distributions and appreciated share value, regardless of whether capital gains rates would normally apply.

### **Working with your insurance advisor**

Insurance planning is an important part of and critical tool in most financial, retirement, and estate plans. Therefore, make sure that you have an advisor who not only understands your particular insurance requirements, but also appreciates how they relate to other aspects of your wealth management plan.

You may find it makes sense to have two different insurance advisors — one for property and casualty insurance (homeowner's, etc.) and another for life insurance.

Your insurance advisor(s) should be clear on how a recommended insurance product fits your needs. The type of policy, the riders attached to the policy, the amount of insurance, the stability of the issuer, and the price for the policy should be reviewed by you and, if appropriate, by other key advisors on your wealth management team. If you already have policies in place, ask an advisor to review them to see whether all are still appropriate for your needs.

It is good to have an advisor who understands your entire insurance picture. Such an advisor can help to ensure that:

- All your insurance needs are being met
- Costly redundancies in your coverage are eliminated
- Premiums are sufficient to continue your life insurance coverage without the policy lapsing
- Risks that could diminish your wealth are minimized

For example, does one disability policy cancel out or overlap another? Does it make sense to replace one policy with a different, updated one? Does your umbrella policy truly fill the gaps in your auto and home policies? Does your property insurance cover all of your jewelry, artwork, and other collectibles? These are questions that you and your insurance advisor will want to address.

***Make sure your advisor not only understands your particular insurance requirements, but also appreciates how they relate to other aspects of your wealth management plan.***

### *Revisiting your coverage*

Your insurance needs will change over time. Consequently, your insurance coverage should be reviewed regularly to ensure that it is still adequate and appropriate.

Be sure that your advisor also obtains a current in-force ledger on your permanent life insurance to review the policy's performance thus far and determine its future performance based on current rates. A periodic review of your permanent life insurance should help ensure that your policy doesn't lapse.

### *Conclusion*

Because effective risk management is a critical component of any sound wealth management plan, you'll want to approach it with due care. While many risk-management options are out there, none should be pursued hastily. By taking ample time to make wise decisions about insurance policies and forms of asset ownership, you can better mitigate the risks posed to your health and wealth, helping to ensure longevity for yourself and lasting value for your family.

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## ***About PwC's Personal Financial Services***

Helping build your wealth and protect it through generations is important to you, and to us. PwC's Personal Financial Services professionals make sure your wealth management plan is customized to meet your personal, business, and family goals.

We help you preserve and grow your wealth through objectively and carefully considered investment strategies, estate and gift planning, charitable giving, personal tax preparation, and business succession planning.

How we deliver these services to you — one-on-one, via a family office, or through a financial program for executives and employees — will depend on your particular situation and preference. One size does not fit all. When the time comes to take this personalized approach to managing your wealth, we are here.



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