Personal Financial Services

Managing your wealth

Guide to tax and wealth management

2017

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Managing your wealth

Guide to tax and wealth management

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Individuals and families that manage their wealth wisely tend to take an active role in doing so. Rather than leave everything in the hands of an advisory team, they make sure they're knowledgeable about the key factors affecting their wealth. This entails understanding various legal, financial, and regulatory issues, as well as the economic and political landscape, both at home and abroad. This can be a tall order—one that our guide aims to help you meet.

As we put the finishing touches on this year's edition, the daily headlines underscore the importance of looking at the big picture, including changes in government office. It will be essential to keep abreast of these and other developments that may affect you and your family. This is especially true if your family has an operating business. You'll need a solid plan to help the family enterprise weather change—both expected, like leadership succession, and unexpected, like potential supply chain interruption post-Brexit.

One trend that merits closer attention is corporate governance for family-owned businesses. To that end, we have responded with a new chapter in this year's guide. Although corporate governance needn't include a board of directors, a family might find that the counsel provided by a board of trustees or directors gives the CEO and key leaders time and space to focus on the big picture and think more strategically.

Succession planning continues to be an important consideration, too. No CEO or founder will live forever, so having safeguards and a plan for the day when the top leadership changes is prudent.

And families, though they go on for generations, are dynamic. As members are added, the type of governance you need may change. There are several ways to do this. We lay them out for you and describe the advantages and limitations of each. You may choose to begin formally preparing members of the next generation to take the reins and have professionals around to make that job easier.

It's wise to begin training the generation behind you in the family's beliefs about what constitutes wise spending and how to preserve wealth.

And as families change, you'll want to be sure you have a shared vision. Communication—listening, as well as talking—can allow younger or newer members of the family to contribute to and understand the family's longstanding values. This can include philanthropic endeavors, which may allow the family to reduce taxes as they work to support causes they believe in.

High-net-worth individuals will pass along wealth, eventually, just as they pass down values now. Managing wealth can be particularly complex as policies and tax laws change. Employing financial, legal, and tax professionals can help, but families must be vigilant in understanding and evaluating their work. You'll need to clearly articulate what risks you are willing to take and how much you want to protect. It's wise to begin training the generation behind you in money management, as well as in the family's beliefs about what constitutes wise spending and how to preserve wealth. Risk management, in other words, which this guide spends a full chapter discussing.

In our guide, you'll also find new and updated information, including details about the following:

- The emergence of the non-tax-exempt LLC as a flexible and innovative component to philanthropic activities
- Recently proposed regulations regarding valuations of interests in family-owned entities and their impact on estate planning considerations
- The use of private trust companies to streamline trust administration across generations while fostering family involvement and education
- New tax return deadlines for the 2016 filing season

We hope you will refer to this guide throughout the year. Chapters on topics such as family enterprise governance and risk management can help you make smart decisions that reflect changes in your family and the world around you. And of course, staying engaged with managing your family wealth—and preparing the next generation to do so as well—can give you peace of mind. Our guide aims to help you do just that, so that you are well-positioned to create value for yourself and for your family, now and in the future.

Sincerely,

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So that your wealth and envisioned legacy survive you, it is important that your intentions be well documented. Equally important is the need to routinely review your estate and gift plans to address any changes in tax laws and to ensure that your wishes remain accurately reflected.

Ch 5

The right corporate governance model can help separate the needs of the enterprise from those of the family. Done well, it brings additional perspectives, broadens leadership's vision, increases accountability, and manages risk—all while keeping the family enterprise's culture and legacy in focus.

Ch 6

The longevity of a family business depends on early and ongoing succession planning. Communicating the results of that planning to family members and other key stakeholders in a timely fashion will increase the likelihood that the business and its value will endure well beyond the leadership transition.

Ch 7

The managerial and administrative needs of high-net-worth families can be extensive, ranging from tax and estate planning to managing trusts and foundations. A family office can help meet those needs, tailoring the breadth and depth of its services to a given family's requirements.

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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. This is especially important in the current environment, where focus on the disclosure, reporting, and taxation of foreign assets has sharpened.

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Protecting your family's well-being and assets from various risks involves more than just obtaining adequate insurance coverage. It also entails making strategic choices about forms of asset ownership. Making wise decisions in these areas will help you preserve your family's health and wealth for the long term.

Chapter 1

Effective tax planning

Effective tax planning can significantly benefit your financial position.

Effective tax planning can be challenging, given the complexity of the US tax code. However, done properly, tax planning can provide significant benefits for your overall financial picture. When income tax rates remain steady, conventional wisdom is to accelerate deductions into the current tax year and defer income until the next. However, there are many provisions within the tax code that can render this strategy ineffective. For instance, accelerating certain deductions may result in a higher overall tax liability if you are subject to the alternative minimum tax. For this and other reasons, it is important that you stay actively involved in your tax planning before and after the 2016 tax year ends. Doing so will help you ensure that the strategy your tax advisor pursues on your behalf will adequately reflect and support your long-term wealth management goals. In this chapter, we discuss tax and wealth management issues that may apply to you, and take a deeper dive into many of them in later chapters.

Scrutiny around compliance of foreign reporting continues as more financial institutions report offshore assets of US individual taxpayers.

Key considerations this tax season

There weren't many significant tax law changes enacted that would impact the 2016 filing season (other than new filing deadlines, as discussed below). This helps to alleviate the complexity of annual tax matters that in many years required time-sensitive incorporation of new legislation into existing tax planning strategies or development of strategies better aligned with that new legislation. However, there are some key considerations to keep in mind this tax season.

Identity theft continues to be a hot topic. Due to numerous cases of identity theft over the last few years, the IRS and many state jurisdictions have implemented programs in an effort to combat this issue and reduce the number of fraud cases. Some examples of this include the individual taxpayer being requested to call the IRS directly on a special hotline and answer a series of questions to verify his or her identity, the taxpayer visiting a particular website to answer a series of online identity verification questions, the taxpayer submitting copies of photo identification along with copies of his or her tax filings, and other similar identity verification techniques. While these requests may, in some cases, delay the processing of a taxpayer's return and, as a result, delay a refund claim, the procedures are intended to protect taxpayers. For more information on identity theft, please refer to chapter 9 of this guide.

Penalties for not having health insurance under the Affordable Care Act (ACA) have increased substantially from 2015 to 2016. For single adults, in 2015, the penalty was the greater of $325 or 2% of income. But in 2016, the penalty rose to $695 or 2.5% of income.[1] For families, in 2015, the penalty was the greater of $975 or 2% of income. But in 2016, the penalty increased to $2,085 per family or 2.5% of income, whichever is greater.

Scrutiny around compliance of foreign reporting continues as more financial institutions report offshore assets of US individual taxpayers. This trend has been pronounced in recent years and seems to be continuing.

New statutory tax filing deadlines will take effect January 1, 2017 (for the 2016 tax filing year) with respect to certain tax forms. The federal tax deadlines are listed on the next page and may directly or indirectly impact individual taxpayers.[2] Note that state tax authorities might not fully conform to these deadlines.

US tax rates

For 2016, married couples who file jointly and have combined taxable income above $466,950 fall into the highest tax bracket of 39.6%, as do unmarried individuals with income above $415,050.

Reflected in the 39.6% rate are tax law changes in recent years resulting from the fiscal cliff legislation and the Affordable Care Act. The latter introduced the Net Investment Income Tax (NIIT)—a 3.8% Medicare contribution tax on certain net investment income, which we will discuss in greater detail later in this chapter.

The highest marginal tax for individual taxpayers whose gross income includes interest, dividends, short-term capital gains, and passive income, is 43.4%, reflecting the combined effect of the

1 The percentage-of-income fee is based on household income minus a tax filing threshold specific to each type of taxpayer (e.g., single, married filing joint, etc.). Refer to www.healthcare.gov/fees/estimate-your-fee/ for more details.

2 Source: AICPA.org

New statutory tax filing deadlines

Return type:	Prior law: original and extended due date	New law: original and extended due dates (dates changed by law in **bold**)	
Partnership (calendar year) ***Form 1065***	April 15 September 15	**March 15** September 15	
S corporation (calendar year) ***Form 1120S***	March 15 September 15	March 15 September 15	
Trust and estate (calendar year) ***Form 1041***	April 15 September 15	April 15 **September 30**	
C corporation (calendar year) ***Form 1120***	March 15 September 15	Before Jan 1, 2026: **April 15** September 15	After Dec 31, 2025: **April 15** **October 15**
C corporation (Fiscal year end other than Dec. 31 or June 30) ***Form 1120***	15th day of month 3 after year-end 15th day of month 3 after year-end	15th day of month **4** after year-end 15th day of month **10** after year-end	
C corporation (June 30 fiscal year) ***Form 1120***	September 15 March 15	Before Jan 1, 2026: September 15 **April 15**	After Dec 31, 2025: **October 15** **April 15**
Individual Form 1040	April 15 October 15	April 15 October 15	
Exempt organization (calendar year) Forms 990	May 15 August 15 November 15 (second extension)	May 15 **November 15**	
Foreign trusts with a US owner ***Form 3520-A***	March 15 September 15	March 15 September 15	
FinCEN ***Report 114***	June 30	**April 15** **October 15**	

Source: AICPA.org

State tax authorities might not fully conform to these deadlines.

NIIT and the regular income tax. For qualified dividends and most long-term capital gains, the combined tax rate for 2016 is 23.8%. Bearing these rates and additional taxes in mind will help you engage effectively with your tax advisor in creating a plan that results in the largest tax savings this year.

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:

- Earned income
- Investment income

Each category has its own set of considerations that taxpayers should keep in mind.

Earned income

Earned income typically comes from wages, self-employment income, bonuses, and retirement plan distributions. The next several pages discuss tax planning strategies aimed at preserving the wealth derived from these income sources.

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.

Before executing a plan to accelerate deductions into an earlier year to reduce your tax bill, be sure to consider how those deductions might impact your tax position. For instance, your deductions might cause you to be subject to the alternative minimum tax (AMT), as mentioned earlier, which would result in the loss of some or all of the tax benefit that the deductions would have otherwise given you.

Even if the AMT is not a factor, determine whether paying expenses early to take deductions could offset income that is taxed at a lower rate (e.g., qualified dividends). If they were to offset such income, that may result in paying more overall tax over a two-year period, as your income may be subject to a higher marginal rate in the subsequent year. In some instances, you may still choose to accelerate some deductions, such as state income taxes, where it will reduce your NIIT. This is likely sensible when you are subject to the AMT every year and have more net investment income in one year as compared to the next. Keep in mind 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 individual wage earners. 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 additional 0.9% Medicare surtax if certain

Top tax rates for personal income

	Wages	Long-term capital gains	Qualified dividends	Passive income	Active income from a general partnership*	Active ordinary income from a LP or LLC*	Active income from an S corporation*
Medicare tax on earned income	1.45%	0%	0%	0%	2.90%	0%	0%
2016 highest marginal income tax rate	39.60%	20%	20%	39.60%	39.60%	39.60%	39.60%
Net Investment Income Tax / Medicare surtax effective in 2013	0.90%	3.80%	3.80%	3.80%	0.90%	0%	0%
2016 top total tax rate	41.95%	23.80%	23.80%	43.40%	43.40%	39.60%	39.60%

* Active ordinary income from partnerships and S corporations is not subject to the Net Investment Income Tax, although, unless an exception exists, capital gains, interest income, and dividend income from these entities will be subject to preferential rates (if applicable) and the Net Investment Income Tax.

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.

thresholds are met. This surtax, which took effect in 2013, is in addition to the regular Medicare tax that has long 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. These contributions lower your current-year taxable income, and the earnings in the plan grow tax-deferred. This will allow you to delay the payment of tax until retirement, while saving for your future.

  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 any matching contribution, if your employer provides one. Missing out on your employer'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.

  Another possible way to defer income is to use a health savings account (HSA). Contributions to an HSA are tax-deductible, similar to 401(k) plans or flexible spending accounts (FSAs). Unlike an FSA, however, any money in your HSA that you don't use during the year is not forfeited and can grow tax-deferred. You can use an HSA much like a retirement plan—you have flexibility with the kind of investments in an HSA, which may include regular savings accounts, money market funds, certificates of deposit (CDs), or mutual funds. An HSA belongs to you, not your employer, so you take it with you when you change jobs. Another benefit, similar to a 401(k), is that your employer can make contributions to the HSA on your behalf.

Business owners' and self-employed individuals' income

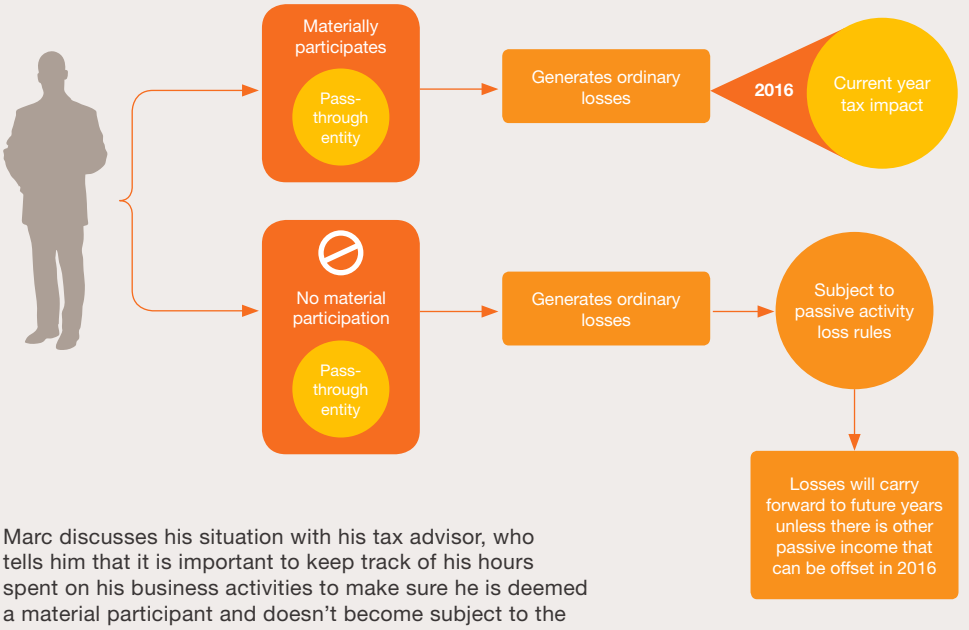
Business owners or self-employed individuals have more flexibility in the timing of their compensation, as well as in when they pay their business expenses. Because income for cash-basis taxpayers is not taxed until it is received or constructively received, self-employed individuals have an incentive to defer billing and collections until January 2017. Conversely, individuals may be inclined to accelerate expense payments into 2016, since doing so will enable expenses to offset 2016 income, thus resulting in current tax savings for the individual business owner. Keep in mind that self-employment income is subject to the 0.9% Medicare surtax 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 the complex passive-activity loss or other loss limitation 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.

Upside to material participation

A potential way to reduce your tax liability

Marc owns his business—a pass-through entity in which he materially participates. During 2016, his business generates losses. Marc is also a partner in a pass-through entity in which he did not materially participate in 2016 and which also generated losses.



Marc discusses his situation with his tax advisor, who tells him that it is important to keep track of his hours spent on his business activities to make sure he is deemed a material participant and doesn't become subject to the complex passive loss rules.

Marc could review his hours within the passive activity and discuss with his tax advisor whether he could group those hours with his business activities so that he is materially participating in both, and all loss will become currently deductible.

Taxpayers can manage income and loss between businesses when they manage participation. Therefore, recordkeeping of business activity is extremely important in order to substantiate any losses not deemed passive. Grouping of activities can help.

Advantages that a 401(k) has over a SEP-IRA include the ability for the individual to take a loan from the plan.

- Bonus depreciation: Additional tax deduction for business owners and landlords
  Special or "bonus" depreciation has allowed taxpayers to claim an additional deduction for certain tangible business property in the year the property was placed in service. Generally, taxpayers have been able to deduct 50% of the cost of certain items placed in service. Although this provision expired at the end of the 2014 tax year, Congress passed a tax extension package, The Protecting Americans from Tax Hikes (PATH) Act of 2015, which modifies, extends, or makes permanent several depreciation-related provisions including bonus depreciation rules. This Act extended bonus depreciation for property acquired and placed in service during 2015-2019 (with an additional year for certain property with a longer production period). The bonus depreciation percentage is 50% for property placed into service during 2015, 2016, and 2017, and drops to 40% in 2018 and 30% in 2019.

- Section 179 deduction
  Some businesses apply a deduction-acceleration strategy whereby they make a Section 179 expense election for certain types of property. This may allow the business to reduce taxes in an initial year by expensing the cost of assets (up to a certain amount) in the year they are placed into service, rather than depreciating the purchase(s) over time. For pass-through entities, choosing this strategy for business assets will directly impact the taxation of the individual owner.

- 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 lesser of $53,000 or 20% of net self-employment income after deducting self-employment tax. Making such a contribution will offset the ordinary income earned in 2016, 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 2016 individual tax return, including extensions (October 16, 2017, if your return is extended). This gives you significant flexibility in timing your contribution and also allows you to determine the exact maximum contribution allowed.

  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 ($53,000); however, the percentage of income limitation on SEP-IRAs and solo 401(k) plans is calculated differently. Solo 401(k) plans generally allow for a higher contribution. However, the higher cost and administrative responsibility associated with these plans should also be taken into account.

  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, you will need to establish the plan early 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 you to receive a lump-sum payment instead of staggered annual payments. The form of payment you choose should depend on your current and anticipated 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

  Converting a traditional individual retirement account (IRA) into a Roth IRA account may create significant financial advantages. The conversion will qualify as a taxable event in the year it occurs,[3] but then the Roth IRA will grow tax-free, and there are no required minimum distributions during the owner's lifetime.[4] Distributions taken from the account are also considered tax-free.

  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 have been eliminated. If after converting a traditional IRA into a Roth IRA, you change your mind, you can reverse your decision up until the extended due date of your 2016 tax return.

  A Roth IRA conversion is something to consider, for example, in years where you might have generated a net operating loss and can therefore offset the ordinary income generated via the conversion. Another good opportunity to convert is when you are able to make a donation of an appreciated publicly traded security to a qualified 501(c)(3) charitable organization. This would allow you to generate a charitable contribution deduction, subject to certain gross income limitations, which would offset the ordinary income generated from the Roth conversion, and save on capital gains taxes, which would have been recognized had that security been sold.

  The Roth IRA can also be a powerful estate planning tool. Generally, a Roth IRA can be passed on to beneficiaries, with future withdrawals receiving tax-free treatment.[5] A surviving spouse who inherits assets in a Roth IRA is permitted to roll them into a Roth IRA he or she owns. In this case, the spouse will never be required to withdraw minimum distributions from the account. Non-spouse beneficiaries must transfer the assets into an inherited Roth IRA and must take required minimum distributions starting no later than December 31 of the year after the account holder's death.

Investment income

Investment income generally encompasses interest, dividends, rents, royalties, capital gains, and certain income from passive investments in partnerships or other pass-through entities. This type of income is generally taxed at ordinary income tax rates, except for qualified dividends and long-term capital gains, which are taxed at a preferential rate of 23.8%. The lower tax rate on these items can help increase 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 with a tax-efficient portfolio. Helpful strategies

3 We strongly recommend that any taxes you end up owing as a result of the conversion be paid from funds outside the retirement account.

4 The Roth benefits are available if the assets within the Roth account have been held in the Roth account for at least five years.

5 If you inherit a Roth IRA, you must take required minimum distributions, but they are tax-free as long as the original account owner held the account for at least five years.

include realigning your personal portfolio to include more tax-exempt municipal bonds and shifting less-tax-efficient investments into retirement accounts, where the assets may grow tax-deferred. These tactics could be especially beneficial for individuals in higher tax brackets. Unlike other types of investment income, tax-exempt municipal bond interest is not considered net investment income for purposes of the Net Investment Income Tax. When reviewing a tax-exempt bond portfolio, state tax implications and AMT implications should also be addressed with your tax advisor.

Intra-family loans

Another investment-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 and the mortgage is duly recorded, the borrower (i.e., your relative) may be able to deduct the interest. By obtaining a loan from you instead of a financial institution, the borrower will pay considerably less interest in the long run.

Capital gains and losses

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 tax-deductible.

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 (short capital gains over short capital losses).

Short-term capital gains realized on the sale of investments held for one year or less are taxed at a maximum rate of 43.4% (the regular income tax combined with the NIIT), while long-term capital gains are taxed at a maximum preferential rate of 23.8%, including the NIIT.

Therefore, you might consider a strategy that ensures that your carryover losses offset short-term capital gains when possible, regardless of whether those losses resulted from short- or long-term transactions. If you have overall net capital losses in 2016, 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 utilized. Capital loss carryovers cannot be carried back to offset previously taxed capital gains, but can be carried forward indefinitely.

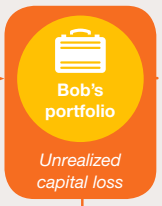
Before the tax year ends, you and your advisors should do a comprehensive review of your portfolio to determine what, if any, investments might be disposed of and whether it makes sense to sell those assets in 2016. For capital transactions that will produce capital losses, it might be best to proceed with those transactions before the end of the year, whereas transactions that will result in a gain might best be deferred.

Harvesting unrealized capital losses

A potential way to offset capital gains

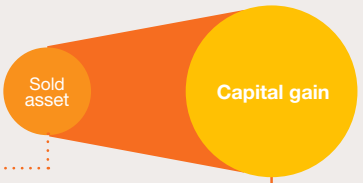
Bob is reviewing his November 2016 monthly statement from his brokerage account. His statement reports that his portfolio is, overall, in an unrealized capital loss position.*

During 2016, Bob sold an asset outside his portfolio, generating a large capital gain.



2016

Bob sold an asset outside his portfolio, generating a large capital gain.



He discusses the capital gain and his unrealized capital loss position with his tax and investment advisors. Bob's advisors tell him that he can harvest the unrealized capital losses in his investment account to offset the capital gain. By doing this, Bob could potentially reduce or eliminate the impact of the Net Investment Income Tax, in addition to the capital gains tax.

Unrealized capital loss

Capital gain

Offset

Before making a decision, Bob should assess whether this tax planning option is in line with his overall investment strategy. He should also take into account the wash sale rules.**

Reduced/eliminated investment income tax and capital gains tax on the capital gain from asset outside his portfolio

* An unrealized capital loss exists when an asset has decreased in value but hasn't yet been sold. Once sold ("harvested"), it becomes a realized capital loss.

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

To be deductible in the current year, your cash charitable contributions to public charities should not exceed 50% of your adjusted gross income.

Wash sale rule

Bear in mind the "wash sale" rule that applies to the disposition of an asset at a loss. You won't be allowed to take the loss if you repurchase the same or substantially identical security within 30 days of the sale date (before or after). This rule ensures that you will not be able to reinvest in a substantially identical investment while recognizing the benefit of a loss on your original investment. Note, however, that this rule does not prevent the recognition of gain on a sale.

Deductions

Given that no tax rate increases are currently scheduled, taxpayers should consider accelerating deductions into 2016, to the extent that tax benefits can be obtained. Taxpayers should also keep a close eye on legislative initiatives aimed at limiting deductions.

Personal exemption and itemized deduction phase-outs

Limits on itemized deductions should be taken into consideration during tax planning. Though rolled back during the previous decade, the limitations, which gradually reduce (phase out) personal exemptions and itemized deductions for high-income taxpayers, were reinstated starting in 2013. High-income taxpayers should therefore pay attention to the phase-out thresholds, as they reduce the tax value of certain deductions.

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 2016, $259,400 for single filers and $311,300 for married couples filing jointly), with a cap applied to ensure that taxpayers do not lose more than 80% of their itemized deductions. Therefore, even if you are subject to the phase-out, additional itemized deductions can still provide a tax savings. This phase-out does not apply to deductions claimed for medical expenses, investment interest expense, casualty losses, and gambling losses.

Timing of itemized deductions

The timing of your itemized deductions should play a role in your overall income tax planning. Generally, taxpayers should consider accelerating 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. Once again, it is important to 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.)

Charitable contribution planning should be done by year-end to ensure maximum deductibility and to determine if any charitable contributions should be deferred until 2017 or accelerated into 2016. 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. Making gifts of appreciated property

can be 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 3 on charitable giving.)

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

Taxpayers may take deductions for business and rental activities in which they do not materially participate but from which they nonetheless derive income (passive-activity income). However, such taxpayers are subject to stringent rules with respect to deducting losses that they derive 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 2016 with passive-activity loss carryforwards should consider pursuing investment strategies that generate passive income, since that would allow use of the passive-activity losses carried over from prior years. 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 broader investment and business strategy.

Passive-activity income (to the extent it exceeds losses) is also subject to the Net Investment Income Tax. There are complex rules that govern the determination of whether an activity is passive or active, especially in situations where the taxpayer owns multiple entities. The NIIT rules also provide an opportunity for owners of passive and active businesses to redetermine their status. You should consult your tax advisor regarding the passive-activity rules.

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 net operating loss two years and any remaining loss is then carried forward for 20 years. On your individual income tax return, however, you can choose to forgo the carryback and make an irrevocable election to only 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 AMT.

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 fully utilize the loss carryforward. 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 seek the refund now, rather than wait for future years' tax savings.

Aircraft: Ownership options

Full ownership

Advantages

- Most flexible option
- Revenue opportunities through charter
- Tax benefits—depreciable asset
- Complete control over plane and crew/consistency
  - Aircraft
  - Service
  - Cost

External management advantages

- Volume pricing on some fixed and variable costs such as fuel, insurance, training, maintenance, and hangar space
- Less required oversight
- Employees not on payroll
- Ability to generate revenue through external charter

Disadvantages

- Complicated and time-consuming
- Residual value and liability risks borne with owner
- Generally highest total cost alternative, though economies of scale minimize this cost disadvantage as utilization increases
- Long-term commitment
  - Capital
  - Staff
- General management requirements
- Limited to your one-size aircraft for all trips

External management disadvantages

- Expensive management cost
- Potential day-to-day variation in crew
- Not likely to get same level of service as with dedicated internal development

Fractional ownership

Advantages

- Professionally managed and maintained
- Guaranteed availability of your plane or a comparable one
- Depreciable asset
- Operating efficiency
- Lower upfront capital outlay
- Highest level of outsourced consistency
  - Crew training
  - Maintenance

Disadvantages

- Generally higher cost than charter
- Capital commitment required
- Limit on number of flying hours during peak holiday periods
- Penalty if utilization does not match share size
- Total expenses do not scale with utilization
- Aircraft upgrades can be costly
- Residual value risk
  - Generally lower-than-average residual value based on high aircraft utilization

Flight cards

Advantages

- Guaranteed availability
- No long-term commitment
- Professionally managed and maintained
- Operating efficiency
- Access to fractional fleet
- Highest level of outsourced consistency
  - Crew training
  - Maintenance

Disadvantages

- Generally higher overall cost than fractional
- Total expenses do not scale with utilization
- Aircraft upgrades can be costly
- No tax depreciation benefit

While the tax code allows certain business deductions for aircraft, rules are complex.

Business deductions for owners and their companies

Strategic tax planning for business owners and their companies should apply 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 business's tax burden, but also on the tax burden of individual shareholders or partners.

Aircraft ownership

The use of personal aircraft as a mode of transportation creates additional opportunities for strategic tax planning for individuals as well as businesses. While the tax code allows certain business deductions for aircraft owned by entities and individuals, the rules are complex. With regard to aircraft ownership and surrounding issues such as depreciation, lease payments, or financing, you should consult with your tax advisor. Refer to the chart on the left page for a more in-depth look at the typical ownership structures, as well as deductions available for the business-use portion of the aircraft.

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, which took effect in tax year 2013.

One was a 0.9% surtax to the Medicare tax on earned income (i.e., employee compensation and self-employment earnings). This surtax increased 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 jointly. Note that the thresholds apply only to earned income. Although the surtax also applies to self-employment earnings, the deduction for self-employment taxes is not increased by the 0.9% surtax.

The tax liability is imposed on the employee, though it imposes withholding and reporting requirements on the employer.

The other stand-alone tax was the 3.8% Net Investment Income Tax (NIIT, as mentioned earlier) on various types of investment income (unearned income) received by individuals, trusts, and estates. This tax is applied to net investment income (gross investment income less deductions allocable to that income), provided it exceeds certain thresholds. The threshold is modified adjusted gross income (taking certain foreign earned income items into account) equal to or greater than $200,000 for single taxpayers and $250,000 for married taxpayers filing jointly. For married individuals filing separately, the threshold is $125,000.

For purposes of calculating the NIIT, investment income falls into three categories. The first is traditional portfolio income such as interest, dividends, annuity income, royalties, and certain types of rental activities. The second includes trade or business income from passive investments, as well as income from trading in financial instruments (common with hedge funds). 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 interests).

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 NIIT, they do increase modified adjusted gross income (increasing the likelihood that the tax will apply).

After combining income and losses from the three categories (to the extent allowed), you are permitted to claim certain deductions (e.g., allocable investment expenses and state and local income taxes) in calculating your net investment income. Depending upon the source of such expenses, you may be able to allocate all or a large portion of your expenses to investment income. It is important to discuss this with your tax preparer to ensure that an appropriate and effective approach is taken.

The 3.8% NIIT applies to the lesser of (1) net investment income or (2) the excess of a taxpayer's modified adjusted gross income over the applicable threshold amount (as discussed earlier). Note that modified adjusted gross income is not reduced by itemized deductions. Further, the NIIT may apply to individuals who are not in the maximum income tax bracket.

Similar to the Section 469 rules in the tax code related to passive activities, the code allows for the regrouping of activities for NIIT purposes in the first year in which a taxpayer is subject to the NIIT. If 2016 is the first year in which you are subject to the NIIT and you have interests in several activities, passive or nonpassive, care should be exercised when deciding whether a regrouping is warranted. Any such regrouping should be discussed with your tax advisor in detail prior to making this election.

Alternative minimum tax

The alternative minimum tax (AMT) causes confusion and concern for many taxpayers. The AMT was enacted 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, real estate 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 applicable to your AMT income is 28%. It is important to note that although the AMT rate is lower than the current regular tax rates, due to the add-back of tax preference and adjustment items, this rate is applied to a larger base amount, which often results in an increased overall tax liability. Qualified dividends and 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.

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

Roger is single. He has wage income of $180,000 and interest income of $30,000.

$180K wage income + $30K interest income = $210,000 modified adjusted gross income

$10,000[1] subject to NIIT

2

Amanda is single. Her wage income is $520,000. She has $45,000 of interest and dividend income.

$520K wage income + $45K interest/dividend income = $565,000 modified adjusted gross income

$45,000[2] subject to NIIT

3

Dave and Anna are married. They have wage income of $425,000 and interest income of $40,000.

$425K wage income + $40K interest income = $465,000 modified adjusted gross income

$40,000[3] subject to NIIT

They sell their principal residence at a gain of $220,000.

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 ($30,000) or income above the threshold ($10,000).

2 The NIIT on $45,000 is the lesser of net investment income ($45,000) or income above the threshold ($365,000).

3 The NIIT on $40,000 is the lesser of net investment income ($40,000) or income above the threshold ($215,000).

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

Oftentimes, taxpayers who find they are subject to the AMT have significant income taxed at the preferential rates, or they may have significant adjustments due to the items noted earlier. Taxpayers who live in states with a high income tax rate (e.g., California and New York) often find themselves owing AMT as a result of high state and local tax deductions on their federal return. As various states attempt to balance their budgets, they may raise their tax rates. These potential rate increases could have a direct impact on your federal income tax liability if they expose you to the AMT.

Legislation passed in 2013 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. However, despite addressing this situation, many upper-middle-class taxpayers may still find themselves subject to the AMT.

It is important to be actively engaged in your tax planning so that you understand how the AMT might affect your tax liability. 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 break-even 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 ordinary income without moving yourself out of the AMT, you could benefit from paying tax at a rate of, at most, 28% instead of the regular tax rate based on your income.

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 full-time students under age 24 will be taxed at the parent's higher income tax rate on investment income that exceeds a threshold amount (for 2016 this amount is $2,100), potentially preventing any tax savings from the shifting of such income to children.

However, the Net Investment Income Tax is assessed on a taxpayer-by-taxpayer basis without regard to parent/child dependent status. Therefore, while the regular income tax may not differ for investment income generated in a parent's name versus a child's, the savings may be in the NIIT, which wouldn't be assessed unless the child individually exceeded the single-filer threshold.

Furthermore, it is also prudent to review a college-aged child's investment portfolio (e.g., a Uniform Transfers to Minors Act account) as there might be some ability to trigger capital

For high-income individuals, shifting income to other family members who are in lower tax brackets generally proves an effective strategy.

gains which could be offset by tax credits such as the American Opportunity Credit or Lifetime Learning Credit. These are typically nonrefundable tax credits which, if unused, don't carry forward from year to year. There might be some opportunity to create a tax-free step-up in basis on holdings within the account by triggering gains to be offset by these tax credits, and then immediately repurchasing the securities (since wash-sale rules don't apply to gain-recognition scenarios). You should separately review with your tax advisor the issues surrounding how a child would qualify to take a tax credit (versus the parent) and potential lost benefits to the parent.

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 sometimes 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 2016 this amount is $2,000), you will be liable for Social Security and Medicare taxes for that person. 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 in order to avoid underpayment penalties.

You should also be aware of informational filings (such as W-2s and 1099s) that you are required to file with the IRS and Social Security Administration. Additionally, state unemployment tax filings are often required for household help.

In addition, we recommend that you consult appropriate counsel to ensure you are adequately insured in terms of workers' compensation coverage and personal liability coverage, and whether forming an entity to serve as the employer may make sense for you. Please see this guide's chapter 9 for more information on insurance.

Foreign investments: Income and reporting

Many US investors include foreign investments in their overall investment portfolio. One benefit to including foreign assets in your portfolio is to participate in the upside of the global economy. These investments are permitted under US tax law but some require additional reporting and compliance. If non-US assets that have a reporting requirement are not reported, even if no tax is due, significant penalties may result. It is important, therefore, that you factor this requirement into your tax planning.

Since all US taxpayers are subject to tax on their worldwide income, the interest, dividends, capital gains, and other income earned through foreign investments are reported on tax returns. Realize, also, that many foreign jurisdictions impose a tax withholding requirement on investment income earned by nonresidents of the jurisdiction, which may reduce your cash flow. However, the US tax code does allow for a credit for such amounts that are withheld and paid to a foreign jurisdiction, subject to foreign tax credit limitation rules. This credit can also potentially be applied toward the alternative minimum tax.

Not only do US taxpayers have to report income from foreign investments, but many are also required to file informational returns disclosing the ownership and value of certain foreign assets. There are two common forms that, if applicable, must be filed to disclose certain foreign asset holdings.

One is the FinCEN Form 114 (previously Form TD F 90-22.1), *Report of Foreign Bank and Financial Accounts* (FBAR). Filing is required if you have a financial interest in, or signature authority over, foreign financial accounts with aggregate balances greater than $10,000 at any point during the year. 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 broad, and many investments that might not seem as though they need to be disclosed are included.

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 returns if they hold certain foreign financial assets that exceed specific thresholds (for example, a US citizen and resident who is married and holds certain 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, and stocks.

The consequences of not complying with the disclosure requirements for foreign assets 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, comprehensive tax planning 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 can help preserve your wealth—not just for your own future, but that of the next generation as well.

Chapter 2

Managing your investments

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

In an environment of uncertainty and global economic inter-dependence, it is important to have an investment strategy that will balance risk and return while remaining flexible enough to capitalize on new opportunities as they arise. It is equally important to monitor your long-term strategies while maintaining sufficient short-term liquidity so that you have accessible capital when you need it.

We recommend that you work directly with your advisors on your investment strategy, seeking to secure gains within your overall portfolio and limit the risk of loss. It is also worth considering that recognizing losses can be beneficial from a tax perspective, as holding onto depreciated investments in hopes of an eventual rebound may do more harm than good. As always, any investment strategy should be consistent with your broader goals, those both near- and long-term.

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 that are realistic and specific.
- Assess constraints, including identifying your disposable income.

Members of your investment team may include money managers, custodians, financial counselors, accountants, and even your adult children.

- 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

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-planning attorney. Careful coordination and communication among these 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 others:

- 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 may serve as your tax advisors on your investment strategies.
- Adult children may be encouraged to participate so that they'll develop the knowledge and skills necessary for dealing with their own finances, understanding the family's investments, and working cooperatively toward wealth management decisions.

As your investment advisory team grows, you'll want to consider selecting one of its members as the team coordinator. That person should work with you and your other investment advisors to maintain and 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 financial markets and current 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 do the fulfillment of continuing education requirements accompanying many of those certifications, 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 provide regular updates on your investments, noting any changes in your investment plan and explaining how they align with your wealth management goals.

Establish 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

Great expectations

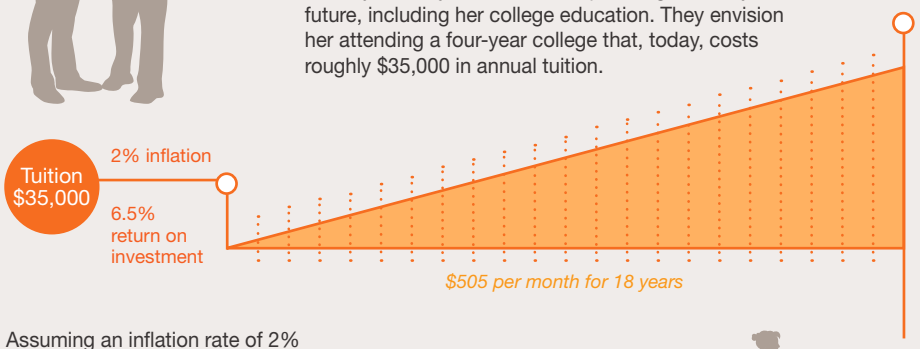
Investing in your child's future

Jeremy and Nicole are parents of a newborn girl, Emily.

Emily needs to go to college. We need to plan for her annual tuition now.

18 years later

Already, Jeremy and Nicole are planning for Emily's future, including her college education. They envision her attending a four-year college that, today, costs roughly $35,000 in annual tuition.



Assuming an inflation rate of 2% and a nominal return on investment of 6.5%, Jeremy and Nicole would have to contribute around $505 per month over the next 18 years to fully fund Emily's college tuition.

Emily goes to college with her projected four-year tuition fully funded in the amount of $206,033.

Current annual cost	$35,000
Annual inflation rate	2.0%
Number of years until first year of college	18
Number of years in college	4
Nominal return on investment	6.5%
Projected college cost	$206,033
Monthly contribution needed to fund cost	$505

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

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.

Assess constraints, including identifying your disposable income

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, 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 it. The IPS can help ensure you and your advisors are on the same page with regard to your investment objectives. However, it is still important to regularly monitor your advisors' adherence to the IPS and benchmark the progress toward your goals. It is also important to revisit your IPS when your goals or circumstances change.

Determine the risk/return tradeoff

The biggest risk you as an investor face is losing money. However, investors cannot obtain a positive return after taxes, inflation, and expenses if they do not take some risk. So even if you are loss-averse, you must take some risk to beat inflation.

Inflation can dramatically reduce the rate of return on your investments. Rather than focusing on your nominal return, you should focus on the return after taking into account inflation and taxes, or the "real" rate of return. By staying focused on your real rate of return, you can calculate whether or not your investments are outperforming inflation. Managing a portfolio with a positive real rate of return on a consistent basis can help ensure your portfolio's purchasing power will grow over time.

Required risk

As noted above, 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, allowing you to determine whether a targeted return is appropriate 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.

Risk capacity

Assessing your risk capacity entails looking at the additional risk (beyond required risk) that you could avoid without jeopardizing your goals. For instance, a 5% real rate of 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%.

Making this determination will reveal the amount of cushion inherent in your plan under 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. The Monte Carlo analysis is a modeling approach that lets the investor see all the possible outcomes of your decisions and assess the impact of risk, allowing for better decision making amid uncertainty. 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 should know how to run the appropriate simulations and draw reasonable conclusions.

Risk tolerance

In order to understand the inherent risk in your portfolio, it is important to have an understanding of the investment environment and the makeup of your portfolio, as well as a general understanding of how financial instruments work.

An investor's personal tolerance of risk is perhaps most instinctively 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 subjective, 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 over the years, particularly as the timeframe for achieving a stated goal narrows 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, which takes into account certain principles now commonly accepted, such as the basic efficiency of the market (i.e., market participants have access to the same information), as well as the virtues of portfolio analysis versus single security analysis. It lays out a structured framework that may help dissuade you from chasing returns or overreacting to unexpected market conditions.

Most investment managers acknowledge that decisions about asset allocation account for over 80% of performance variability over time.

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. A vigilant investment team can recommend adjustments to your portfolio that are tactical and strategic, rather than changes that are reactive, emotional, 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 correlated 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 highest returns.

Asset allocation as diversification

Asset allocation is the process of selecting asset classes and efficiently allocating capital to those asset classes. This is accomplished by matching expected rates of return to a specified tolerance for risk. By using asset allocation, investment planning is more than just selecting the right stock, bond or property to place in a portfolio. It is about aligning the makeup of your overall portfolio with your specific investment objectives.

Your overall portfolio allocation should be consistent with your objectives and goals.

Diversifying across the broad-based asset categories (cash, fixed income, equities, alternative investments, and hard assets) should reduce the risk associated with concentrating your investments in just one or two categories.

You may need to consider a different allocation for any funds you set aside for retirement, education expenses, or other goals, due to possible differences in your investment philosophy when factoring in the potential variations in investment time horizon and your associated risk tolerance for each goal.

In asset allocation, portfolio advisors generally consider these broad-based asset categories: cash, fixed-income, equities, alternative investments, and hard assets. These asset categories are described as follows:

- Cash and cash equivalents are investments that can be liquidated in a short time period, and usually include checking/savings accounts, money market funds, and short-term government issues.
- Fixed-income assets are investments that generate interest income. They are usually debt instruments and include securities such as corporate and government bonds and various asset-backed securities.
- Equities are investments that may share in the

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 depositary 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 associated with international investments that you should consider in the context of your overall investment strategy.

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

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

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

appreciation or depreciation of an asset. These investments may include small company stock, "blue chip" corporate stocks, and certain limited partnership investments.

- Alternative investments may be either equity driven or debt driven and may involve investing as a limited partner in either a hedge fund or private equity fund. Underlying assets may include various combinations of other asset categories. There may be tax advantages to investing in these types of vehicles versus stocks or bonds, but they also may add layers of complexity to your tax position.
- Hard assets are often used as a hedge against inflation. These investments include real estate, gold, foreign currency, and natural resources. Many individuals invest in these indirectly through stock in companies or exchange-traded funds (ETFs) that invest in such assets (e.g., gold stocks, energy ETFs, etc.).

Although no one can guarantee that a certain asset allocation will produce a stated investment return, the proper diversification within the portfolio can help reduce risk. A portfolio that optimizes the potential rate of return while minimizing risk is known as an "efficient portfolio."

Sub-category allocation

In addition to diversifying across the broad-based asset categories mentioned previously, many individuals also diversify their investment portfolios by allocating across different investments within a category, otherwise known as sub-category allocation. Sub-category allocation allows you to further refine your portfolio to ensure that it is consistent with your goals, risk tolerance, and time horizon. Generally, sub-allocations are limited to fixed-income and equity investments. However, you could also diversify your cash and hard assets by allocating these assets in some of the many investment alternatives available within each of those categories.

One common method of sub-category allocation within the fixed-income category is bond laddering. Commonly employed by investors nearing retirement, this approach involves staggering the maturity of the bonds in a portfolio. This method (1) reduces interest-rate risk, because a portion of the bond portfolio will often be nearing maturity and (2) often matches the investor's cash flow needs with the bonds' value upon maturity.

It is important to be mindful of the various categories of diversification. For example, investing in short-term bond funds might provide diversification among numerous short-term bonds, but it does not address diversification within that duration category. Further diversification can be achieved by also investing in intermediate- and long-term bonds, and in the issuer category, by investing across municipal, corporate, and Treasury bonds.

Alternative investments

Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, more-limited regulation, and relative lack of liquidity. Alternative investments may include hedge funds, private equity funds, managed futures, real estate, commodities, and derivatives contracts.

Many alternative investments have high minimum investments and fee structures compared to mutual funds and ETFs. As they are generally subject to less regulation, published performance data is less available, and many

Some of the most common alternative investments that you may be in a position to consider are within the hedge fund and private equity fund space.

such investments are not advertised to potential investors through conventional methods.

Alternative investments are favored largely because their returns have a low correlation with those of other asset classes. Because of this, many large institutional funds such as pensions and private endowments, as well as high-net-worth individuals, have allocated a portion of their portfolios to alternative investments.

Some of the most common alternative investments that you may be in a position to consider are within the hedge fund and private equity fund space. Within the hedge fund space, you may be aware of hedge funds that either take a position that they are a trader in securities, meaning they have a shorter-term investment perspective and turn over their portfolio more frequently, or take a position that they are an investor in securities and have a longer-term investment perspective, seeking more of their returns via capital appreciation over time. It is important to understand what the implications are of each prior to investing, as the tax benefits and consequences can differ greatly. Below are some things to consider prior to making an investment in a hedge fund or private equity fund:

- Tax treatment of management fees, investment interest expense, etc.
- Do you anticipate receiving a tax benefit and how does that factor into your calculation of return on investment over the life of the investment?
- Are the deductions taken as an adjustment to gross income or as an itemized deduction subject to limitations, phase-outs, and alternative minimum tax issues?
- Additional non-resident state filing requirements (generally more common in the private equity fund space)
- Will you have an opportunity to participate in state composite tax filings and minimize overall costs?
- State tax issues regarding treatment of expenses, especially in states that either phase out deductions for high-income taxpayers or assess a tax on gross income, without accounting for itemized deductions
- More frequent review of tax basis within an investment to address any issues arising from current-year losses, distributions, etc.
- Is the fund foreign or domestic, and does the investment create additional regulatory disclosure at the individual level or add an additional level of complexity in terms of informational reporting required to be submitted with your individual income tax return?
- Are these investments more opportune when developing gift-planning strategies given the statistically greater chance of higher average returns (while measuring risk) versus stocks, bonds, etc.?

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 market conditions, and rebalancing on a regular basis to ensure that the overall portfolio stays within those parameters. Strategic allocation is founded on modern capital market theory and assumes that additional research and

economic analysis will not result in greater investment performance over the long term. This technique tends to be less expensive, as it is more conducive to a passive investment strategy, which in many cases does not require an active money manager or investment advisor.

- 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. This technique normally requires the skills of a portfolio manager or an investment advisor actively making transactional decisions in order to meet the desired results.

Both approaches may 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, 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.

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 the highest return for the accounts they manage. 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.

Achieving tax efficiencies through strategic asset placement

Income taxes matter in the investment process. With the rise in tax rates for high-income taxpayers and the introduction of the Net Investment Income Tax in 2013, income taxes have come to the forefront in many investment discussions. It is important 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 top marginal income tax rate is 39.6%. For 2016, the top tax rate will apply to married couples who file jointly and have combined taxable income above $466,950 and to unmarried individuals with income above $415,050.

There is also the 3.8% NIIT for single taxpayers with modified adjusted gross income over $200,000 and for married couples, filing jointly, with modified adjusted gross income over $250,000.

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 satisfy. Investments of high-net-worth 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 in order to 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.

Another attractive aspect of deferral accounts is that they avoid not just current regular income taxation, but also the potential Net Investment Income Tax of 3.8% on annual investment income, whereas earnings in taxable accounts may be subject to that tax. Accounts such as Roth IRAs, health savings accounts (HSAs), and college savings plans offer potentially tax-free investment opportunities and may allow different time horizons.

Which investments to own within 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 sense, because the 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 and still meet your goals.

Developing and implementing your portfolio investment strategy

Once you have determined your appropriate asset allocation, the next step is to work with your advisor to develop and implement your investment strategy.

Developing your investment strategy

Developing your investment strategy is the process of reviewing your current asset allocation and determining how best to deploy or redeploy your investable assets to achieve your desired asset allocation. When developing your investment strategy, there are several approaches available. The two most common methods are reallocating your current investment and deploying cash available for investment.

In addition to considering strategic and tactical asset allocations when developing your investment strategy, you should also consider whether an active or passive investment approach is right for you.

Active investing: This is an investment strategy where an investor continually monitors their holdings and frequently buys and sells investments in an attempt to extract additional returns. An active investing strategy can be employed by an individual investor, money manager, or a fund manager. This investment technique is generally more expensive than passive investing due to the increased administrative costs such as trading and management fees.

Passive investing: This is an investment strategy where an investor buys and holds an investment with the intention of realizing long-term appreciation. An investment strategy that follows an index, such as the S&P 500 index, is an example of a passive investment approach. This investment strategy can also be adopted by investing in a mix of individual stocks and bonds, mutual funds, and exchange-traded funds. It is generally a lower-cost means of investing because of the limited administrative costs.

Implementing your investment strategy

After developing an investment strategy, you and your advisors will want to act on the plan. When implementing an investment strategy, there are several investment options available. Some investment options include individual stocks and bonds, mutual funds, exchange-traded funds, and certain types of alternative investments.

Individual stocks and bonds: Investing in individual stocks and bonds provides for great flexibility in terms of investment choices. However, this style of investment is generally within the purview of advanced investors and money managers due to the time and effort needed to both research potential investments and to acquire enough individual stocks and bonds to have a well-diversified portfolio.

Mutual funds: With this type of investment vehicle, a mutual fund money manager invests in securities such as stocks, bonds, and/or money market funds on behalf of many investors. Mutual funds generally invest in one asset class (e.g., large-cap stocks). Some mutual funds do, however, invest in several asset classes to

Rebalancing your portfolio also presents a good occasion to monitor your holdings and compare your investments.

create an allocated fund based on a prospective investor's risk tolerance and time horizon. The major benefit to investing through a mutual fund is instant diversification. Mutual funds can be actively or passively managed. Funds that are passively managed generally follow a specific index, such as the S&P 500.

Exchange-traded funds (ETFs): This type of fund is similar to a mutual fund, except that the fund trades like an individual stock. An ETF's price fluctuates throughout the day as it is bought and sold on the open market. Most ETFs are passively managed by following an index, but some ETFs are actively managed by fund managers. ETFs generally charge lower management fees than mutual funds, which has helped their popularity.

Alternative investments: These types of investments include hedge funds, private equity funds, managed futures contracts, other option trading, derivatives, etc. Although more complex, and not as prevalent as the investments noted above, investment strategies that incorporate these asset types can provide valuable diversification to a portfolio with significant upside potential. Depending on the asset class, expenses are treated differently for tax purposes and there may be complex tax reporting to consider before making such investments. Opportunities may be limited due to minimum capital requirements for entry, but for those who have capacity, there are several domestic and foreign options available.

Review your portfolio's performance

Every year, you should revisit your allocation in light of changes in your personal profile, years to your next goal, your risk tolerance, and your investment mix. If any of these factors should change significantly, your asset allocation would require an adjustment.

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 within a particular 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 you may also be enhancing your returns.

Rebalancing your portfolio also presents a good occasion to monitor your holdings and compare your investments with their respective benchmarks or asset classes. However, it's smart

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

to take 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 (quarterly or annually) is crucial.

Fees and expenses

While it is reasonable to expect to incur some level of expense and fees while investing, it's smart 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 underscored 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 vary by type of investment. For example, a mutual fund generally has a 12b-1 fee of 1% or less.
- Annual account fee: This is sometimes charged by brokerage houses to cover expenses such as 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.
- 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 timeframe. Such fees are 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.

Investor behavior

Goals often change over time. Therefore, what may be a goal or objective today could be different 20 years from now. In addition, you may have one or more short-term needs, such as paying for a child's education or purchasing a vacation home. Therefore, investment planning should be an ongoing process that has a long-term focus but also accounts for short-term needs.

People often pay too much attention to current market or economic conditions. As a result, they make short-term decisions. You need to look at your investments in relation to your goals, not in relation to what is happening today in the market. In other words, you must be fully aware of your internal concerns, not just external conditions. If you invest solely on the basis of changing market conditions, you will probably make serious mistakes. But if you invest with your goals and objectives in mind, you can usually weather short-term market fluctuations.

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

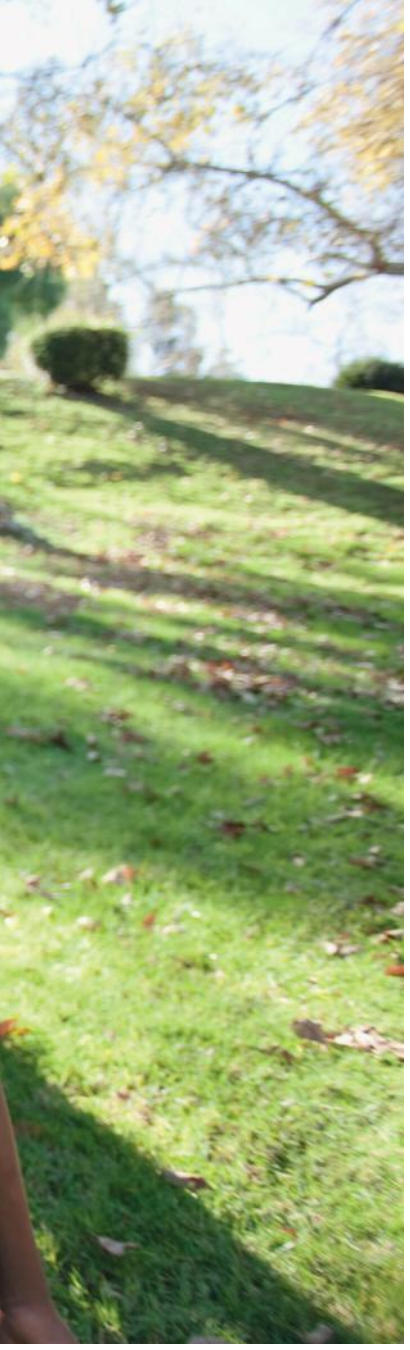
Generally speaking, investor behavior tends to mirror the current state of the economy and the business cycle: If things are looking good, investors tend to be positive; if things start to take a turn for the worse, their attitudes turn negative. Most investors focus on the present (job situation, current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

Ideally, an investor would be slightly ahead of the crowd, selling before markets fall and buying before they 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 proved effective in managing risk and capturing reasonable returns—is a systematic asset allocation based on the time horizon associated with a particular investment goal. This, combined with a well-documented strategy (or investment policy statement) and periodic rebalancing, can go a long way toward keeping your investment behavior and game plan on track.

Conclusion

Investment planning is a complex undertaking. While it is rooted in fundamental principles, it must be approached differently in the case of each individual's or family's needs and expectations. By working closely with your team of advisors on a well-considered investment strategy, you can help ensure that you achieve your wealth management goals now and in the future.


MAKE A
DIRENCE



Chapter 3

Charitable giving

Supporting charities and transferring wealth can complement a family's wealth management strategy.

Without private philanthropy, few charitable organizations would survive, and yet their existence 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 part of a potential income stream. Some people may simply wish to create a legacy of family giving, with tax benefits being a secondary 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.

Charitable structures

There are a number of commonly used charitable structures. Each carries different tax and non-tax implications, which need to be taken into careful consideration. Once you decide on the type of structure that best aligns with your charitable goals, 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. 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 control.

Many charities strongly prefer gifts of cash or publicly traded securities.

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).[1] 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 are dedicated to improving the lives of people in a defined geographic area. These foundations can serve multiple charitable organizations and therefore 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 accommodating of gifts of this nature, due to their local and familiar presence within their region.

Donor-advised funds

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

While donors do not have a legal right to mandate that their donated funds be used in a particular manner, most charities are willing to consider the donor's wishes. Likewise, although the administrator of a DAF 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 DAFs is that they give high-net-worth individuals flexibility in aligning their tax-planning strategies 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 subject to the same deduction limits as gifts to public charities. Many donors choose to fund these plans with highly appreciated securities instead of cash. Doing so generally provides an upfront tax deduction for the fair market value of the securities gifted, and also allows the donor to avoid paying federal and state income taxes upon the eventual sale of the securities.

1 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, you should consult a tax advisor about the potential value of the deduction. In many cases, a donor is eligible to receive a fair-market-value deduction for such a gift only if the donor has held the appreciated security for more than one year.

Donor-advised fund

Reducing your tax liability in the near term while benefitting others in the long term

Jennifer, who turns 50 this year, has a significant portfolio of appreciated securities. Jennifer expects her adjusted gross income (AGI) to be approximately $750,000 in 2016, with a marginal tax rate of 40%.

She has always had an interest in being philanthropic but did not plan to make significant charitable contributions until later in life—that is, until she was advised that there was an opportunity for her to reduce her tax liability for 2016 by making charitable contributions now.

Jennifer decides to contribute $50,000 in appreciated securities to a donor-advised fund (DAF). By doing so, she avoids paying capital gains tax on the sale of those securities and she also receives an income tax deduction in 2016 that is equal to the fair market value of the assets donated ($50,000), thus reducing her income tax burden by $20,000.

Going forward, Jennifer can advise the DAF on which charities she would prefer her contributions be distributed to each year.

The charitable deduction for contributions of appreciated property to DAFs cannot exceed 30% of the taxpayer's AGI.

$750,000 (Jennifer's AGI)
x 30% = $225,000

Since Jennifer's donation doesn't exceed the 30% limit, she gets the full tax deduction of $50,000, saving her $20,000 (40%) in the current year. Please note that charitable deductions may be subject to other limitations.

What Jennifer gives

Stock with a fair market value of $50,000 → Donor-advised fund

What Jennifer gets

Current year income tax deduction of $50,000 and the ability to make recommendations on which charities receive future distributions from the DAF

You may want to weigh the comparative advantages and disadvantages of donor-advised funds against those of private foundations.

Also noteworthy is that donor-advised funds can provide many of the same benefits as private foundations, but without the administrative requirements and formalities that are associated with private foundations. For example, DAFs provide the following: a current-year charitable deduction with the ability to release the funds to charities in future years, degrees of intergenerational control, the public recognition and legacy enhancement associated with incorporating the family name into the name of the fund, and a vehicle to educate younger generations on charitable giving and wealth management. Some DAFs also offer research and support in identifying recipient public charities whose mission is consistent with the donor's philanthropic objectives. Therefore, when determining the best means of achieving your charitable goals, you may want to weigh the comparative advantages and disadvantages of donor-advised funds against those of private foundations.

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

- Fee structure
- Types of assets the fund will accept
- Minimum distribution requirements (if any) from sponsoring organizations
- 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)
- Limits on how long a family will have influence over its donated funds (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 and donor-advised funds, private foundations generally pay a 1% or 2% excise tax on their net investment income, including capital gains. Founding donors have responsibility over foundation operations, including investments, tax filings, and the giving process.

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 by law 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 nonoperating private foundations are fully deductible up to 30% of a donor's adjusted gross income (AGI). Gifts of appreciated publicly traded stock to nonoperating private foundations are generally deductible up to 20% of a donor's AGI. The donor's deduction that is subject to the 20% of AGI limitation will be the

fair market value of the donated assets if held for longer than one year, while the deduction will be limited to the cost basis of the appreciated donated asset if held less than one year. Gifts of appreciated non-marketable assets (e.g., land, art, etc.) to a nonoperating private foundation are deductible but are limited to the asset's cost basis. A key benefit of an operating private foundation, by contrast, is that gifts to it are subject to the same AGI limits as gifts to public charities (i.e., 50% of AGI for cash gifts and 30% of AGI for appreciated securities). Regardless of whether the foundation is categorized as operating or nonoperating, any gift exceeding 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 a multigenerational plan for charitable giving. Before creating a private foundation, however, high-net-worth families should consider the requirements related to recordkeeping, tax filing, public disclosure, and other administrative tasks associated with 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. Full-service investment advisors may provide an array of services to the foundation, including fiduciary administration and grant-making support (including research support in identifying public charities with particular goals and missions) in addition to investment management. These and other issues associated with creating and managing a private foundation should be discussed with your tax and investment advisors 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 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.

For tax-deduction purposes, a supporting organization is treated as a public charity. It does not pay an excise tax on net investment income and is not subject to the same minimum distribution requirements as a nonoperating private foundation.

The latest evolution in charitable giving is being driven by new economy entrepreneurs.

Non-tax-exempt LLC

The latest evolution in charitable giving is being driven by new economy entrepreneurs. Just as these individuals have brought new ideas to the marketplace, they have also brought a new paradigm to philanthropic activities.

Traditional charitable giving structures, such as private foundations and donor-advised funds, are typically designed to allow a person to make a large contribution to an entity and take a current charitable income tax deduction for the entire amount even though actual distributions are not made to charity until later. The cost of this prefunding of a charitable deduction reflects the additional administrative requirements, strict rules, and diminished control over investment and other activities associated with these arrangements.

More recently, innovative people seeking a broader array of ways to achieve their philanthropic objectives, and who are less concerned with a current charitable deduction, have used non-tax-exempt limited liability companies (LLCs) as part of their charitable giving plan. Under this arrangement, assets earmarked for charity are transferred into an LLC. An LLC with this purpose is treated like any other LLC—it is not a tax-exempt entity—and the individual is not entitled to a current charitable deduction on its funding. In satisfying its charitable mission, the LLC makes future distributions to charities, and the individual receives a charitable deduction in the years the distributions are actually made from the LLC to the charity.

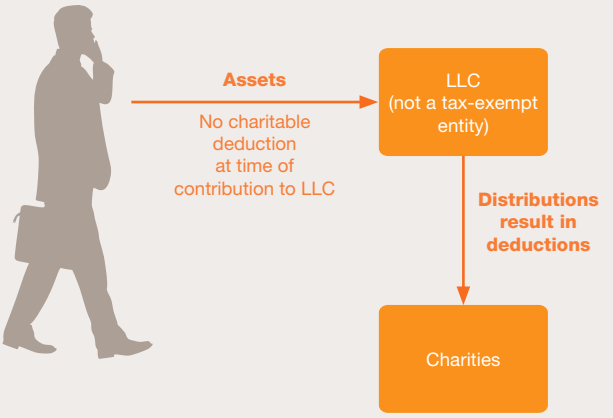
In other words, non-tax-exempt LLCs do not provide the benefit of claiming a current deduction upon prefunding the LLC, such as you'd get with private foundations, donor-advised funds and other charitable vehicles. However, when compared to private foundations and some other charitable alternatives, some of the advantages of using a non-tax-exempt LLC (and hence, waiting for a charitable deduction until distributions are actually made to a charity) include:

- No restrictions on donations, and a potentially wider range of philanthropic projects
- Avoiding extensive administrative burdens, rules, and oversight associated with private foundations and other charitable alternatives
- Greater flexibility in connection with investment activities/options and increased control over operations
- No public filing requirements, which means more privacy around philanthropic activities
- Assets contributed to the LLC are not irrevocably restricted to charitable purposes—they can be returned to LLC members
- Ability to better manage potential loss of charitable deductions due to carryover limitations

Non-tax-exempt LLC

How does it work?

Jason and Mary are philanthropically inclined and want maximum flexibility to positively impact society. They create a non-tax-exempt LLC to avoid restrictions, constraints, and oversight associated with traditional charitable planning vehicles. There are no restrictions on the type of advocacy, donations, or investments they can undertake. While they will not receive any deduction on funding the LLC, deductions are available for gifts from the LLC to qualified charities.



Comparison to private foundations

ADVANTAGES:

- Avoid restrictions, administrative requirements and state attorney general oversight (including mandatory distribution rules and rules against self-dealing, excess business holdings, jeopardy investments, and taxable expenditures)
- No *public* annual filing requirement
- Greater flexibility, leeway, and control over operations
- Assets contributed to LLC are not permanently restricted to charitable purposes (can be distributed to LLC members)

DISADVANTAGES:

- No charitable income tax deduction in year assets are contributed to LLC
- LLC members do not receive charitable income tax deduction until LLC makes contributions to charity
- LLC is not tax-exempt—for tax purposes LLC is treated like any other LLC and all income flows through to LLC members

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.

A 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 a popular kind of deferred gift. 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, based on actuarial tables.

Remainder interest in a personal residence

A popular method of mitigating estate tax on a personal residence (e.g., a residence that is not your primary residence but is, say, a vacation home or a farm) while gaining a current income tax charitable deduction is to give a remainder interest in that property to charity. While the remainder interest is transferred to charity, the donor is responsible for all real estate taxes, utilities, insurance, and normal repairs and maintenance of the property since the donor retains the right to use and occupy the residence.

The income tax charitable deduction is based on the present value of the charity's remainder interest. For estate tax purposes, although the personal residence would be included in the individual's estate, an offsetting charitable deduction would be available.

Conservation easement

A charitable contribution deduction is also allowed in connection with the transfer of a perpetual easement (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. Some examples of conservation easements are those that preserve land for outdoor recreation by the general public; protect a habitat of fish, wildlife, and plants or a similar ecosystem; preserve open space (including forests and farms); or preserve 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 property's fair market value had been before the easement was granted and comparing that amount with the property's fair market value after the easement was granted.

A charitable remainder trust generally does not pay income tax on investment earnings.

Charitable remainder trust

The charitable remainder trust (CRT) offers various structures of deferred giving 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 present value of the remainder interest given to the charity. It is important to consider, however, that the present value of the remainder interest earmarked for charity must be at least 10% of the value of the entire property. A CRT falling short of this 10% requirement may be declared void. However, if the CRT is declared void, the trust can be re-formed to meet the 10% test.

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 (at least 5% of that value and no more than 50%) is paid to one or more noncharitable beneficiaries at least annually.

A CRT can last for either the donor's lifetime (or the lifetimes of several income beneficiaries) or no more than 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 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.

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 paying current income tax, capital gains tax, or the 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 distributions received from the trust. Distributions from CRTs may also be subject to the 3.8% Net Investment Income Tax, which will mean additional recordkeeping requirements at the trust level.

Sometimes, beneficiaries of a CRT want to terminate the trust early. There are a variety of reasons for terminating a CRT early: the income beneficiary may no longer need the annual payout and wants to get trust assets to the charity, the income beneficiary may need a current lump sum amount rather than a stream of future payments, or the costs of administering the trust may have become too burdensome. A CRT may be terminated early either by donating the income interest of the beneficiary to charity or by making a lump sum payment to the income beneficiary, equal to the current value of the remaining annuity payments they are to receive. Should the income interest be donated, the income beneficiary would likely be able to claim a charitable deduction for the

In today's interconnected world, charitable giving by US individuals has an increasingly global reach.

current value of the income interest given to the charity. If, instead, the income beneficiary of the CRT receives a lump sum payment equal to the current value of the remaining annuity payments, the full amount of the lump sum payment would be treated as a capital gain by the income beneficiary.

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). The charitable interest is in the form of a fixed percentage of trust assets or a guaranteed annuity. 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 provided that 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 file a tax return and be entitled to an income tax charitable deduction generally equal to the value of the annuity paid to charity to use against the CLT's own income. Another benefit of creating a nongrantor CLT results from the fact that the NIIT is computed differently for trusts than for individuals. Generally, charitable deductions do not reduce an individual's NIIT; however, they do reduce a trust's NIIT. So a nongrantor CLT could use the annual payments it makes to charity to reduce this additional tax.

Important gift tax and estate planning objectives can be achieved through the use of a nongrantor 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 received by the charity.

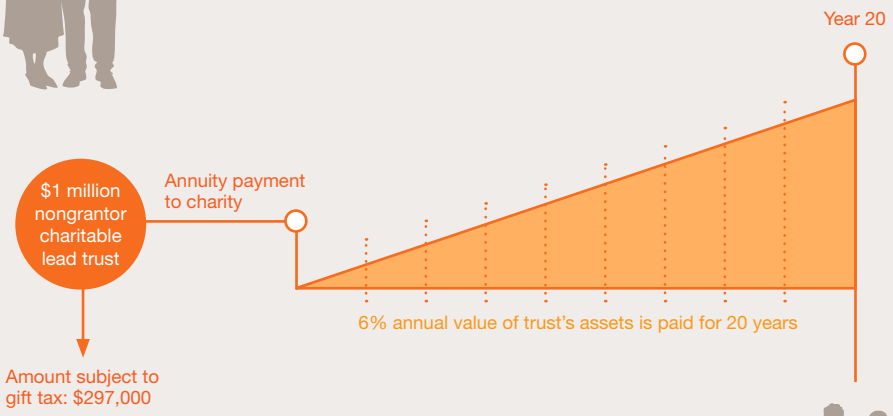
International charitable giving

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 significant 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

Helping charities now, while investing in future generations

Mark and Amy transferred appreciated securities with a value of $1,000,000 into a nongrantor charitable lead unitrust. Each year, the trust is required to pay an amount to Mark and Amy's favorite charity—an enrichment program for inner-city youth. The payout is set at 6% of the trust's annual value over a 20-year term. At the end of 20 years, the remaining assets will pass to Mark and Amy's children.



Remaining assets pass to 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 charity—decreasing a $1,000,000 gift to approximately $297,000.*

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

Mark and Amy will not be entitled to an income tax deduction because they set up the trust as a nongrantor trust and therefore are not taxed on the trust's annual income.

Additional tax benefit

A nongrantor trust is generally permitted to use annual charitable contributions to reduce its Net Investment Income Tax (NIIT)—whereas charitable deductions typically do not reduce an individual taxpayer's NIIT.

* This reduction is calculated by using IRS tables in the month of the contribution, at an assumed rate of 1.8%.

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 fees for setup and annual maintenance
- Provides the donor with administrative support related to its charitable giving
- Creates no annual tax burden
- Comes with fewer concerns about penalties relating to self-dealing, failure to distribute assets, etc.
- Permits a degree of intergenerational transfer of control, though generally not for as long as a private foundation does
- Can give senior family members an opportunity to educate the next generation on charitable giving and wealth management
- Provides a level of anonymity for donors seeking discretion

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 and types of assets accepted by the fund 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 selection of 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
- Gives senior family members an excellent vehicle for developing an intergenerational charitable giving plan and for educating the next generation in wealth management

Disadvantages

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

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

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

Conservation easement

Advantages

- Grants the donor a current charitable deduction with minimal cash or property outlay by the donor
- 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
- Fair market value of property is potentially reduced as a result of the permanent restrictions

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
- Additional tax compliance and administrative expenses may be incurred

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
- Additional tax compliance and administrative expenses may be incurred

Non-tax-exempt LLC

Advantages

- No restrictions on donations, and a potentially wider range of philanthropic projects
- Avoids extensive administrative burdens, rules, and oversight associated with private foundations and other charitable alternatives
- Greater flexibility in connection with investment activities/options and increased control over operations

Disadvantages

- No up-front current charitable income tax deduction upon funding the LLC
- The LLC has to file a tax return (although not subject to public inspection) and pass-through income and deduction items to the members of the LLC

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 and contact their tax advisors 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 recipients or the types of property that are used to satisfy the charitable gift donation. However, because there are complexities in implementing a postmortem charitable strategy, proper steps should be taken to ensure that the estate tax charitable deduction isn't lost.

Deciding if charitable gifts fit your wealth management plan

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 options entail careful planning. 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 recipient 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 recipient provided any goods or services in consideration for the contribution. If the recipient 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 (i.e., before the tax return is filed), the charitable contribution won't be permissible (even if the recipient can subsequently prove that the contribution was made).

Property contributions of more than $500

If a donor contributes property valued at more than $500 (e.g., art, car, stock), 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 required for contributions valued at more 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 is to be reported on Section B of Form 8283, which must then be signed by the appraiser and the recipient organization. If the contribution of property is valued at more than $500,000 during the tax year, a copy of the qualified appraisal must be attached to the tax return.

Misconceptions

As with most areas of wealth management, charitable giving has certain misconceptions associated with it. The biggest may be that the financial benefit of charitable giving lies solely with the recipient, when in fact such giving can also create an income stream and potential tax savings for the donor.

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) and receive written acknowledgement from a qualified charity. Contributions that are not deductible include those made to individuals, as well as those made to:

- 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.[2] 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 deductible by attendees. In other instances, however, those costs might not be deductible, so be careful that you don't 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 achieve certain wealth management goals. An experienced advisor can help dispel confusion and recommend charitable giving options that are compatible with your objectives.

2 Although the value of a volunteer's time or services does not qualify as a charitable contribution, with respect to certain unreimbursed car expenses incurred in the course of providing services to a charitable organization, a volunteer can deduct either (1) the actual cost of certain out-of-pocket expenses, such as gas and oil, or (2) 14 cents per mile. The volunteer can also deduct the unreimbursed cost of parking and tolls associated with the charitable activity.

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.

Chapter 4

Estate and gift planning

Proper estate and gift planning 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. That's why it's critical 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 priority you give them—are likely to change over time. For that reason, it's wise to review your estate plan periodically to ensure that it evolves as your goals and circumstances do.

Estate and gift tax rules for 2016 transfers

Tax implications are an important consideration in the development of any estate plan, and the estate and gift tax rules have undergone numerous changes over the years. The estate, gift, and generation-skipping transfer (GST) tax exemption amounts are uniformly set at $5 million, as indexed for inflation each year (the amount of the exemptions is $5.45 million for 2016). The top estate and gift tax rate is 40%.

Estate and gift tax rates and exemptions for 2016	
Highest estate/gift tax rate	40%
Estate tax exemption	$5.45 million*
Gift tax exemption	$5.45 million*
GST exemption	$5.45 million
Gift tax annual exclusion	$14,000

* The unified credit amount may be used during life to exempt gifts from federal gift tax and, with any remaining unused amount, to transfer property at death free of federal estate tax.

The table above illustrates the estate and gift tax rates and exemptions that are in effect for 2016.[1]

This means that married couples can now transfer a combined $10.9 million ($5.45 million for each spouse) free of estate, gift, and GST tax during their lifetimes or upon death.

The benefits of portability

Portability allows the surviving spouse to use the deceased spouse's unused estate and gift tax exemption amount during the surviving spouse's lifetime to make gifts or have the amount 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, however. Some states that impose a separate state estate tax recognize portability of the state estate tax exemption between spouses, but many states do not. Of course, relying on portability alone may not be the best route. Assets given away during life can escape tax on any appreciation between the date of gift and the date of death. Therefore, relying on portability could mean the loss of a significant opportunity during life.

When is an estate plan the right choice?

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

Lack of an estate plan could result in 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 your property immediately when you prefer that they not receive it before they reach a certain age, or your children inherit all or a portion of your estate, when in

1 Eighteen states and the District of Columbia have some form of estate and/or inheritance tax. You and your advisors should check to see whether there are differences between the estate and gift tax laws on the federal level and the laws in your jurisdiction.

fact you intended to leave everything to your surviving spouse or partner, or vice versa

- An unsuitable property transfer—e.g., property transferred directly to a person who is uninterested in or incapable of handling the property, so that the property might have been better left in trust, or, conversely, property placed in a trust when circumstances warrant giving the property directly to the beneficiary
- Disadvantageous ownership of assets (e.g., 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 your 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 likely to change as well. Periodically contemplating the factors noted here is therefore a good idea.

Estate planning: A four-step process

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

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

Step 1: Assess your current situation

The first step in any plan is to review your current financial situation and personal objectives. In reviewing your financial situation, an effective starting place is to create a personal 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 or some other form of ownership; 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 (e.g., life insurance policies, retirement plans, deferred compensation, etc.)

It is a good idea to make your estate plan sufficiently flexible that it remains applicable if circumstances change.

- Evaluating the appreciation potential for various assets[2]

After reviewing your financial situation, you should assess your personal objectives. Key considerations include the following:

- Maintaining your current standard of living and planning for your future standard of living
- Providing for your surviving spouse/partner and dependents
- Naming guardians for your minor children
- Designating someone to make financial and healthcare decisions in the event that you or your spouse/partner becomes incapacitated
- Maintaining control over your assets during your lifetime
- Ensuring that your property is distributed in accordance with 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
- Achieving your charitable goals and establishing your family's legacy

It's essential to determine how important each of these objectives is to you. You should review any existing wills, trusts, and other wealth management documents to see if they are consistent with your current goals. 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.

Step 2: Determine planning options

Using the information gleaned from the assessment stage, you can begin to determine which estate-planning techniques best suit 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. It is a good idea to make the plan sufficiently flexible so that it remains applicable if circumstances change—without going too crazy to cover every contingency.

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 still worth having, since it can be used to name guardians for minor children and specify who will receive

2 A major benefit of making lifetime gifts is that, after the date of the gift, 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.

which assets and when. Keep in mind, though, that many states give to a surviving spouse certain rights to a deceased spouse's property that can't be defeated by a will. This is known as a right of election, meaning that the surviving spouse under certain circumstances can elect to take a specified share of property instead of what is provided by the will. Care needs to be taken to coordinate these rules with the estate plan.

Be prepared in case of incapacity

It's also useful to complete "durable power of attorney" and healthcare proxy forms. These documents specify who can make financial and healthcare decisions for you if you should 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 GST 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 available tax exemptions. As discussed earlier in this chapter, the federal portability law may allow you to take full advantage of both spouses' exemptions. However, there are requirements that must be met in order to qualify for exemption portability. Relying on the portability of the exemption can also expose you to the risk of future changes in these rules. As noted earlier, the GST tax exemption is not portable and many states do not permit portability of the state exemption. 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 the survivor 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. However,

The recipients of several types of assets are not controlled by your will.

owning property and assets in this manner may provide creditor protection benefits so this needs to be balanced with the estate tax implications.

Another consideration to keep in mind is that if you live (or used to live) in a community property state[3] 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 who is the named titleholder. 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 controlled 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.

Disclaimer planning

A disclaimer is a refusal to accept a gratuitous transfer, usually an asset received by a beneficiary through inheritance. If a beneficiary disclaims an asset, the asset passes to another beneficiary—most often going to the person(s) who would have received the asset if the disclaiming beneficiary was deceased. There are several reasons to disclaim an asset. For example, a beneficiary may want to avoid finding himself or herself in a taxable situation because he or she may have a taxable estate of his or her own, or he or she may not want to add to an already large estate.

Another reason to use a disclaimer is to allow a surviving spouse to determine what assets are retained by the spouse and what assets pass to other beneficiaries (usually in trust). This gives a couple a "second look" at the estate plan at the death of the first spouse. If the surviving spouse already has significant wealth, for example, he or she may decide to disclaim the asset, thereby passing it to the children or other beneficiaries.

If a disclaimer is done properly, the asset then passes to the beneficiary next in line, usually as if the original beneficiary was deceased. The person who disclaims the property cannot specify who receives it instead. There is no additional estate or gift tax as a result of this type of "qualified" disclaimer.

There are specific requirements for making a qualified disclaimer. For example, the disclaimer must be made within nine months of the date of the transfer (i.e., date of death for inherited property). Individuals considering a disclaimer should speak with their advisors to ensure the disclaimer is timely and fulfills all requirements of state property law as well as the federal and state tax law requirements.

3 Nine states operate under community property rules: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (Alaska's community property system is elective; both spouses must opt in). Keep in mind that many non-US jurisdictions have rules similar to those of community property states.

Planning for unusual and unique assets

Ownership of unusual and unique assets (e.g., artwork, wine collections, book collections, jewelry, sports memorabilia, etc.) can create complications upon death if you do not adequately plan for the disposition of these assets. Disputes among family members, issues of ownership or authenticity and matters relating to the legality of transfers may result from improper planning.

Unusual and unique assets often have sentimental value, so it is important to determine who will want these assets, or if they should be sold outright or donated to charity. You may want to give away these assets during your lifetime using your annual gift tax exclusion. Further, these assets are generally valued at fair market value at date of death, so it may be beneficial to acquire an appraisal of these assets during life so that you can ensure your property is distributed by value according to your wishes.

Consider the form and amount of property left to your spouse

For most 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 will best help you 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 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 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. It is therefore advisable to discuss this potential responsibility with your spouse before making a decision.

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

The estate and gift tax exemption rules allow taxpayers to significantly reduce the estate tax owed.

"general power of appointment" trust is the only type of trust 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 a 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, outright transfers to the spouse will generally not qualify for the unlimited marital deduction (unless the spouse becomes a citizen within a relatively short time) and a trust will qualify for the unlimited marital deduction only if the property passes to a qualified domestic trust (QDOT). A QDOT has special rules and requirements that need to be addressed in the trust document, as well as strictly followed each year in order to maintain the marital deduction.

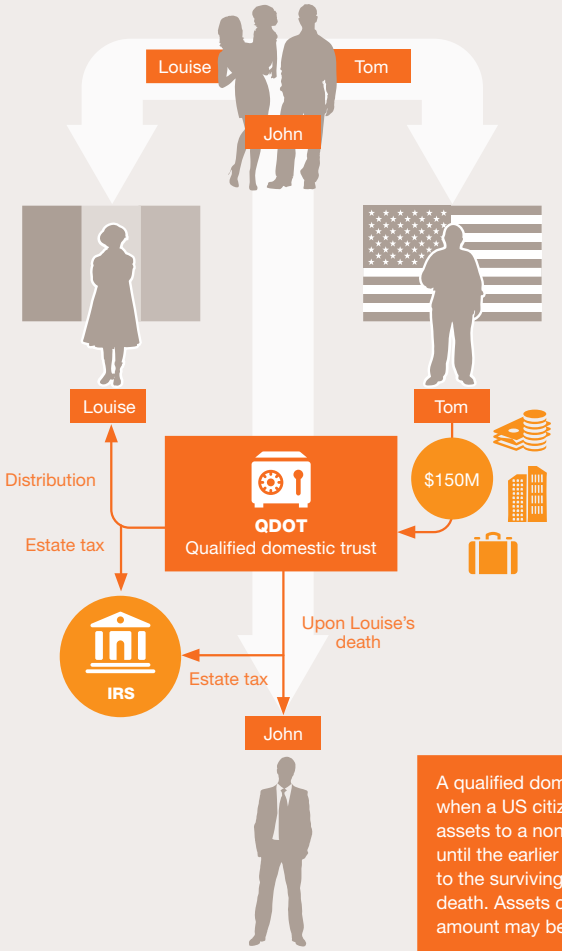
Take advantage of the estate tax exemption

Spouses are each entitled to an estate tax exemption of $5.45 million for 2016, which can be used after their deaths to protect that amount from estate tax (to the extent this exemption was not utilized during life to make gifts). 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 may be portable, meaning that it can be added to the second spouse's exemption to offset the estate tax. Also, as previously noted, the generation-skipping transfer tax exemption is not portable between spouses under current law.

The estate and gift tax exemption rules allow taxpayers to significantly reduce the estate tax owed through outright transfers to beneficiaries other than a spouse or charity, transfers to trusts that benefit both the spouse and other beneficiaries, and the potential use of disclaimers by the surviving spouse, among other methods.

Qualified domestic trust (QDOT)

Planning for your non-US-citizen spouse



Tom, a US citizen, lives in New York. with his wife, Louise, a Belgian citizen, and his son, John, a US citizen. Tom is a founder of a publicly traded company and owns several real properties around the world, including one commercial building in New York. His total net worth is approximately $150 million.

During a business trip, Tom, unfortunately, dies of a heart attack. As a successful businessman, Tom had an estate plan in place that included a QDOT for the benefit of his wife. All of Tom's assets pass to a QDOT, resulting in no estate tax due at his death. The QDOT currently holds $150 million worth of assets. The trust only pays estate tax when there is a principal distribution to Louise. No estate tax will be imposed on income distributions to Louise.

However, had Tom not set up a QDOT, the estate would need to pay $60 million in estate tax* to the IRS immediately.

A qualified domestic trust (QDOT) defers federal estate tax when a US citizen spouse dies and leaves a large amount of assets to a non-US-citizen spouse. A QDOT defers estate tax until the earlier of the time distributions are made from the trust to the surviving spouse or the time of the surviving spouse's death. Assets could be invested to maximize income since this amount may be distributed estate-tax-free.

In order to qualify as a QDOT, the trust must meet certain requirements designed to ensure the collection of the estate tax imposed on the trust.

* Estate tax rate is 40% in 2016. This assumes that Tom had already exhausted his $5.45 million exemption during his lifetime.

For more information on QDOTs, please refer to chapter 8 of this guide.

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 exclusion. 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 2016, 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.

Consider trusts and family entities as part of your wealth transfer strategy

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.

Estate planning—increased focus on income tax

In the past, estate planning focused primarily on making lifetime gifts and other transfers to reduce the amount of assets subject to estate tax at death. The emphasis on income tax planning as part of the estate planning process has increased in recent years due to several changes, including:

- Maximum federal income tax rates increasing from 15% on capital gains and 35% on ordinary income to 20% and 39.6%, respectively.
- Maximum federal gift and estate tax rates decreasing from 55% (60% in some cases) to 40%.
- The increase of the gift and estate tax exemption from $675,000 in 2001 to $5.45 million, with an annual increase for inflation
- The option to elect portability of deceased spouse's unused estate tax exemption
- Enactment of 3.8% Net Investment Income Tax (NIIT).

One thing that has not changed is that the basis of assets held at death is "stepped up" to fair market value, effectively eliminating the income tax on any pre-death appreciation. Conversely, a recipient generally receives a "carryover" basis in assets given away during life, meaning that the recipient's basis is equal to the donor's basis and will be subject to income tax on the appreciation when selling the asset.

Estate planning before the changes

- Focus on making lifetime gifts to prevent estate tax from being imposed upon future appreciation. Due to the disparity between the estate and income tax rates, the estate tax savings on such appreciation tended to be greater than the increased income tax caused by the "carryover" basis associated with lifetime gifts.
- Lower estate tax exemption meant significantly fewer assets could be held until death to get an income tax basis "step-up" without an estate tax cost (increasing the potential benefit of lifetime gifts).
- Leaving assets generating income in respect of a decedent (assets that effectively do not get a "step-up" in basis, such as IRAs, 401(k)s and other retirement assets) to charity.

Estate planning after the changes—increased income tax focus

- Decrease in focus on lifetime gifts. The combination of a decreased estate tax rate and an increased income tax rate lessens the difference between estate tax savings and the increase in income tax due to the loss of the basis "step-up."
- Larger estate tax exemption significantly increased the amount that can pass estate-tax-free—increasing the amount of assets that can be held until death to get an income tax basis "step-up" without an estate tax cost.
- Gifts to shift income. Increased income tax rates and the NIIT may increase focus on gifts of assets to recipients in lower income tax brackets for future income tax savings.
- Increased focus on flexibility—such as using disclaimers and providing executors and trustees with greater discretion—to allow the plan to be more easily adapted to changing tax and other circumstances.
- Leaving assets generating income in respect of a decedent to charity.

A GRAT allows you to retain the right to receive, for a specified term of years, an annuity stream. A GRAT works best with assets that are likely to appreciate rapidly.

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 GRAT, 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 and estate 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, because you must survive the term of the trust in order for the assets to be removed from your estate.

Although no changes to the GRAT rules have yet been made, various proposals have been set forth over the years that, if enacted, would make GRATs less beneficial. Among other things, some of the proposals would have required 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 low, it may be wise to consider establishing a GRAT sooner rather than later.

Dynasty trust

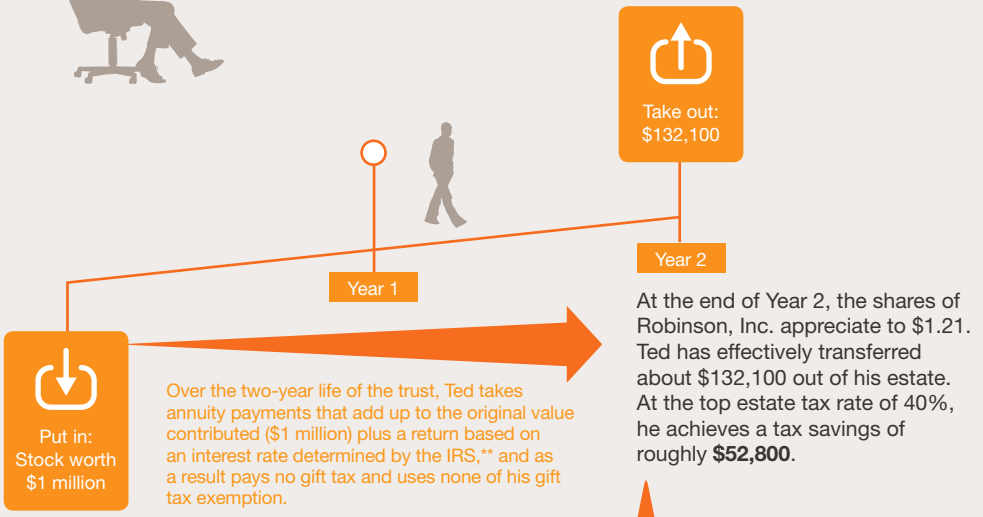
A dynasty trust is generally created as part of a plan to mitigate the impact of the generation-skipping transfer (GST) tax. This is an additional tax applied against the value of property that's transferred to people who are defined as "skip persons." A skip person is someone who is two or more generations 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 in fact collected on the transfer of wealth from one generation to the next. As noted earlier, the GST tax exemption for 2016 is $5.45 million. 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 may 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.

GRAT gratification

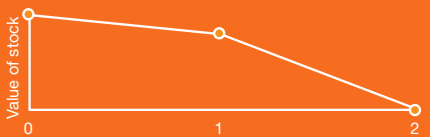
How one business owner achieves substantial estate-tax savings

Business owner Ted Robinson creates a two-year grantor-retained annuity trust (GRAT),* transferring to it one million shares of Robinson, Inc. stock, valued at $1 per share (total value **$1 million**).



Over the two-year life of the trust, Ted takes annuity payments that add up to the original value contributed ($1 million) plus a return based on an interest rate determined by the IRS,** and as a result pays no gift tax and uses none of his gift tax exemption.

At the end of Year 2, the shares of Robinson, Inc. appreciate to $1.21. Ted has effectively transferred about $132,100 out of his estate. At the top estate tax rate of 40%, he achieves a tax savings of roughly **$52,800**.



If Robinson, Inc. stock were to decline in value or stay the same during the GRAT's term, all of the stock would be returned to Ted in payment of the annuity and remain in his estate (worst-case scenario), making him no worse off than if he had done nothing.

* Note that GRATs work best with assets that are likely to appreciate rapidly. You should consult your tax advisor before setting up a GRAT to realize the full tax benefits.

** For purposes of this example, we are using an assumed interest rate of 2%.

If you're contemplating setting up an IDIT, it may be a good idea to do so sooner rather than later.

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. 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 a rate of return that exceeds the specified interest rate, 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 in connection with the generation-skipping transfer tax.

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 within the IDIT—hence, the trust is "defective." The reason that an IDIT is nonetheless an appealing option is that the income tax payment provides an income and estate 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 generated 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 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.

Sell instead of give outright

It could reduce your estate tax down the line

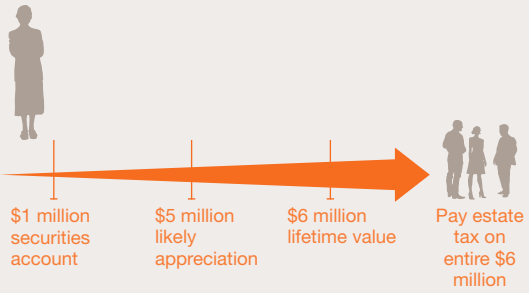
Susan, a retiree in her sixties, has a securities account worth $1 million. Her investment advisor tells her that the account is likely to grow by $5 million, reaching a total of $6 million in her lifetime.

Susan wants to give the securities to her three children. She has already used her lifetime gift tax exemption* through prior gifts, so gift tax would be due on the current $1 million value if she gives the securities now. Estate tax would be due on the $6 million value at the time of her death if she waits to bequeath the securities under her will.

After consulting with her accountant and estate attorney, it was recommended that she instead sell her securities to her family dynasty trust in exchange for a note.

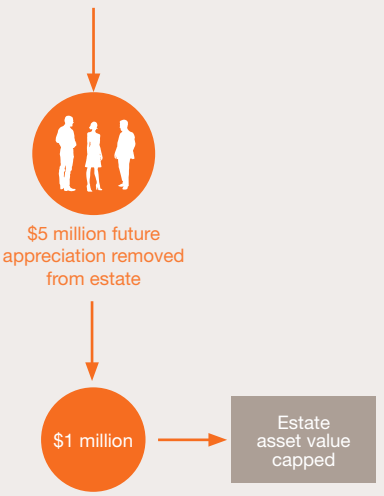
The result? Susan eliminates about $5 million of future appreciation from her estate and caps the estate value of this asset at $1 million. Additionally, income tax would not be due on the sale or the note interest payments if the trust is set up as a grantor-type trust.

If Susan had bequeathed the securities through her will, her family might have ultimately paid estate tax on any value above her remaining exemption amount, as well as estate tax on the appreciation of the $7 million.



Alternative scenario

Susan sells the $1 million of securities to her dynasty trust



* In 2016, the lifetime gift tax exemption is $5.45 million.

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 trustee may decide to rent the home to the grantor. This is an excellent means to further reduce the estate.

A QPRT is especially desirable when (1) significant 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.

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 effectively 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. This may allow the death benefit proceeds to escape estate taxation immediately, rather than three years later. For more details, please see chapter 9 of this guide.

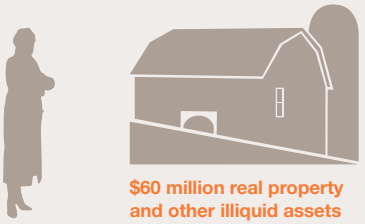
Charitable trust

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 noncharitable beneficiaries of your choosing. For more details, please refer to chapter 3 on charitable giving.

Life insurance trust = future liquidity



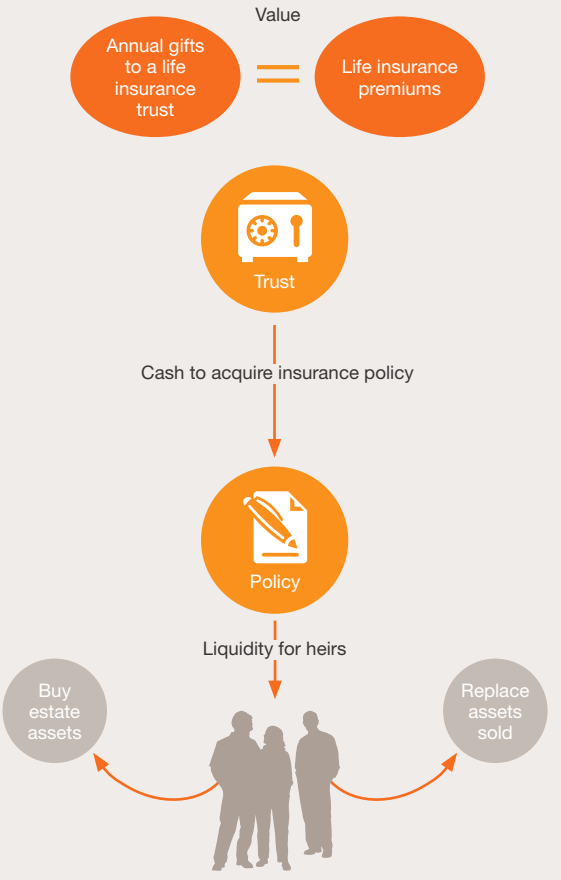
$60 million real property and other illiquid assets

Rebecca has a $60 million estate, consisting mainly of real property and other illiquid assets. Consulting her CPA, she learns that the estate tax due at her death may result in her executor being forced to sell the real estate and other illiquid assets over a relatively short period of time.

To plan for this situation, Rebecca forms a trust to purchase insurance on her life. By doing so, Rebecca creates liquidity and provides flexibility for her heirs. The cash in the life insurance trust can be used to buy illiquid assets from her estate, giving the estate cash to put toward paying the estate tax or, alternatively, the cash can be used to replace assets that the estate sells to pay the tax.

Rebecca makes annual gifts to the trust that equal the value of the premiums.

A properly drafted trust allows Rebecca to use the annual gift tax exclusion ($14,000 in 2016) to help her avoid using her lifetime gift tax exemption.



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. Keep in mind that many foreign jurisdictions' forced heirship rules cannot be changed by will—although they can sometimes be defeated by planning during life. Additionally, if you do not have a will, the law of the applicable US state where you reside generally determines who receives your property. Many other countries have similar laws governing who will receive your property if you die without a will, and conflicts and additional administrative costs can arise if the laws of the US and the other country specify different people as the recipients of your property.

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.

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. For example, the marital deduction for US estate tax purposes (allowing spouses to pass unlimited amounts to each other without a US estate tax) applies only if the surviving spouse is a US citizen or if a special QDOT trust, discussed previously, is used.

Extra care should be taken when establishing family partnerships, as they are routinely scrutinized by the IRS.

Family limited partnerships

A family partnership is an excellent way to manage 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, either of which is 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 a 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 are complete.

Additionally, there is a level of asset protection associated with family partnerships. The partnership unit ownership can be restricted to family membership or to trusts for family members. 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.

Extra care should be taken when establishing family partnerships, as 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.

In August 2016, the IRS issued proposed regulations that substantially limit discounts from being used in valuing gifts of certain family-owned entities. The new proposed regulations, once finalized, are expected to dramatically change the landscape of how family limited partnerships are used in estate planning.[4]

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.

4 To learn more about the proposed regulation, please see *The End of Valuation Discounts in a Family Business Context?* PwC, August 23, 2016.

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 important, the attorney must ensure that the documents are properly executed in accordance with state law.

Implementation also involves producing an estate tax balance sheet that reflects the flowchart to illustrate how the estate will pass according to the new plan.[5] 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.

5 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 vice versa for the second.

Step 4: Monitor the plan

The final step in the estate planning process is to review and monitor your plan periodically. Over time, you may find it necessary to adjust 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 important either to modify your estate plan or to create a new one.

It is also important to evaluate your estate plan routinely 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 well into the future.

Chapter 5

Family enterprise governance

The right corporate governance model can go far to increase accountability and manage risk.

Individual- and family-owned enterprises (family offices, family businesses) are vital to our economy. If you or your family owns such an enterprise, you understand how important its success is to your personal wealth and to future generations. If you're a nonfamily executive at a family enterprise, you also recognize that its profitability and resilience are vital to your job security and financial well-being.

Increasingly, family enterprises have grown interested in corporate governance, as evidenced by changes they've made to their boards over the past decade. While some family enterprises have a board only to satisfy legal requirements, more are moving toward the outer rings of the family enterprise corporate governance model shown on page 81. Ultimately, owners will decide which governance level best suits the enterprise's current needs and determine when changing circumstances mean the company's governance should transition to another ring.

Compliance board

While most incorporated enterprises are required, by state law, to have a board, the requirement may be as simple as maintaining a board of at least one person who meets at least once a year. An enterprise's board may consist of only the founder. In the early stages of a founder-led enterprise, this type of board may well be the best fit for the company, since the founder is usually more focused on building the enterprise than on governance.

69% *of leaders at* ***145*** *family-owned/owner-operated enterprises say they have a formal board of directors acting on behalf of company owners to oversee the business and management.*[*]

Insider board

Such a board often includes family members and members of senior management. This type of board composition can better involve the family in the enterprise, help with succession planning, and introduce additional perspectives to board discussions. The insider board may be created by the founder—who might no longer be the CEO—or by the next generation of owner(s). That said, the founder/owner(s) retain decision-making authority.

Inner circle board

In this type of board, the founder/owner adds directors whom he or she knows well. These may include an accountant, lawyer, or other professional who guided or influenced the company, as well as include the founder's close friends. These directors might bring skills or experience to the board that otherwise would be missing and may be in a position to challenge the founder/owner(s) in a positive way. Such boards might create an audit committee or other committees. However, the founder/owner—who may or may not be the CEO—holds the ultimate decision-making authority.

Quasi-independent board

This level introduces outside/independent directors who have no employment or other tie to the company apart from their director role.[1] These directors introduce objectivity and accountability to the board and they expect their input to be respected. Board processes and policies will likely become more formalized with outside/independent directors on the board. The number of committees may also increase. This outermost ring on the family enterprise corporate governance model is the level of governance that most resembles what you would see at a public company.

Governance at any family company will be determined almost exclusively by what the founder (or family members who control the company) wants. You might have a compliance board or an inner circle board—and those may be entirely appropriate for where your company is now. Numerous family enterprises have benefited greatly from moving toward the outer rings in the governance model—especially when anticipating a generational transition. But each family enterprise situation is unique, and so the rings in the corporate governance model provide a framework rather than a specific roadmap.

Advantages of evolving your governance model

"Inner circle" or "quasi-independent" boards can add tremendous value to family enterprises, specifically in the following ways:

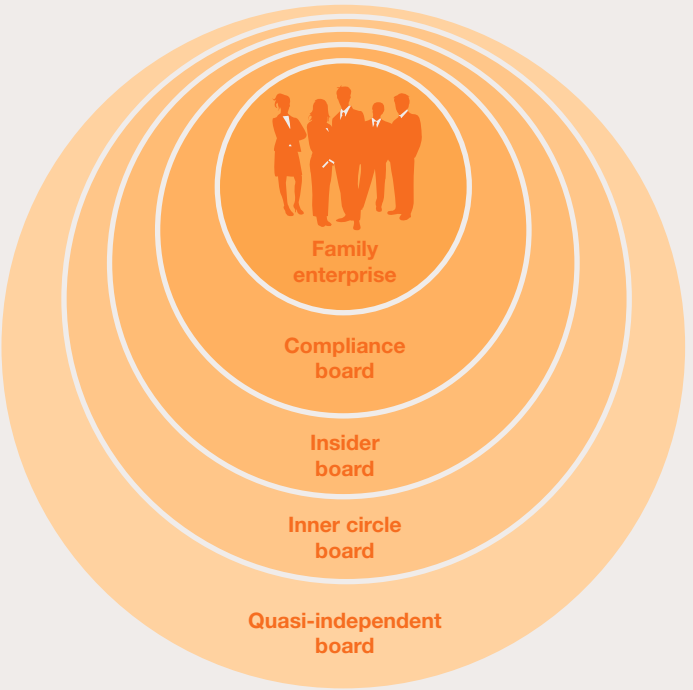
Separating company needs from family needs

Especially in a company's early years, founders and family members may view company assets as belonging to them. Removing assets—such as significant amounts of cash—from an enterprise can impact the enterprise's health, and even its viability. It can also have tax and regulatory consequences. Directors can ask questions about how the enterprise's assets and profits are used. They can also moderate discussions about the appropriate level of dividends for shareholders. This can help ensure that the enterprise retains sufficient funds to survive and thrive.

1 For a fuller discussion of independent/outside directors, see the publication *Building or Renewing Your Board* in PwC's Family Business Corporate Governance Series.

* Source: *Trendsetter Barometer,* PwC, 2013

*Family enterprise governance model**



* Some companies also have an advisory board to advise management and directors. Advisory board members don't vote or have fiduciary responsibilities.

Some family enterprises falter when passing control of the company from one generation to the next.

Adding perspectives, experience, and networks

Directors can leverage what they've seen elsewhere to help managers anticipate and address problems—or perhaps avoid them in the first place. Some directors may also bring deep industry experience, which can be helpful when setting and implementing the enterprise's strategy. Plus, directors often have extensive networks that can prove helpful to the enterprise in other ways.

Helping the CEO look beyond tactical issues

CEOs, especially in smaller family enterprises, often find themselves caught up in day-to-day operations, with little time to think strategically about the enterprise. Discussing strategy with a board can help the CEO focus on the big picture and spot trends, changes in the marketplace, and new opportunities.

Increasing accountability

Regular board meetings can help instill discipline in the executive team, as managers will need to report on strategy, projects, financial results, and other matters.

Enhancing risk management

Directors can bring an outside perspective and discipline through overseeing risk management. They may bring different views on the importance of the risks that management has identified, and encourage executives to devote appropriate resources to mitigating those risks.

Bringing objectivity and independence

Often a company founder or CEO is the champion for certain projects and/or people. This can ensure that a project will be given the needed resources and leadership attention. Sometimes, however, management might not recognize when a project isn't working and should be abandoned. Outside directors (i.e., nonfamily or nonmanagement) can bring objectivity that helps management make hard decisions. And those directors might also be in a better position to deliver difficult but necessary messages to the CEO.

Planning/advising on CEO succession

Because no CEO or founder lives forever, succession planning is critical. While a planned, orderly succession is ideal, a sudden illness or death could create a leadership vacuum. If the founder or CEO hasn't considered succession, a board can encourage him or her to address it properly. Indeed, in an emergency, an experienced director could even step in temporarily, until a permanent leader is found.

In the case of planned succession, the board can assist by encouraging the CEO to identify possible replacements and ensure that internal candidates work in operational roles geared toward preparing them for the possible chief executive role.[2] Directors can also participate in coaching and mentoring family members who have joined the enterprise and may aspire to run it one day. Given family dynamics, directors outside the family may be in a better position than a parent or relative to identify strengths and coachable areas in a CEO's son or daughter (or niece or nephew). And those younger family members may be more receptive to receiving and acting on advice from someone outside the family. By helping family members develop into effective business leaders, a board can improve the odds of a successful leadership transition within the family.

2 For a discussion of succession planning, see chapter 6 of this guide, as well as the publication *CEO Succession Planning* in PwC's Family Business Corporate Governance Series.

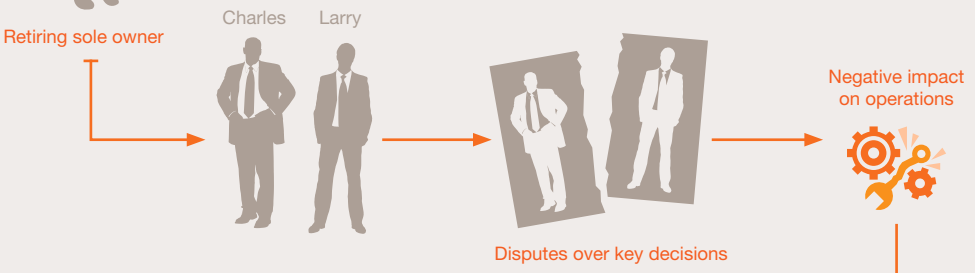
Building a board function for a family enterprise

Creating structure for decision making and strategic vision

No formal board structure

Lisa, the founder and sole owner of a successful family enterprise, is getting close to her planned retirement age. Her two sons, Larry and Charles, both work for the family enterprise.

The company does not have a formal board structure. After Lisa's retirement, Larry and Charles assume joint ownership of the company and soon get into a dispute over key decisions facing the business.



Because of the turmoil and lack of future vision, other key employees leave the company. The brothers cannot resolve their differences and are forced to sell the company at a deflated value.

Unfortunately, the family had not created a formal board, which could have provided a structured decision making function for the enterprise, including documented voting rights and dispute-resolution procedures. During the transition from a sole owner, whose decision making was absolute, to siblings, with shared decision making, a formal board structure would have increased the likelihood of success.

The inclusion of outside (nonfamily) board members is also a best practice for family enterprises, allowing them to leverage outside experience and counsel, as well as provide strategic and long-term advice.

If you're the controlling shareholder, you have final say, regardless of what your board might suggest.

Creating a safe harbor

If something goes wrong in a family enterprise—especially if it involves a family member—employees or outsiders may find it easier to report concerns to directors who are not family members or part of the management team. The board can then decide whether to investigate further.

Smoothing ownership transition to the next generation

Some family enterprises falter when passing control of the company (which may be different from changing the CEO) from one generation to the next. An established board can provide continuity and guidance to a younger generation and help preserve the founder's vision for the enterprise. Effective directors build relationships with new family members who are added to the board.

Planning/advising on exit strategies

Sometimes passing the enterprise down to the next generation isn't the best move to maximize shareholder wealth or to ensure the company's ongoing survival. A board can provide advice on whether the generation in control should:

- Sell the company to a competitor or to employees
- Merge with another company
- Take the company public
- Wind the company down

Family enterprises also may have outside investors, and these investors may have a time horizon for their exit from the enterprise. A board can provide input on exiting with minimal disruption to the company.

Possible concerns about changing your governance model

It's all well and good to talk about the value a board can bring, but it's not unusual for founders to have concerns about adding individuals to their board who aren't either family members or close friends. Here are some of the common concerns and possible ways to address them.

Reluctance to give up control

If you're the controlling shareholder you still have final say, regardless of what your board might suggest. You can also draft your delegation of authority policy to preserve the decisions you want to make.

Discomfort sharing confidential information with outsiders

One way to avoid sharing confidential information with outsiders is by appointing only insiders (family and management) to your board. If you later choose to add other directors, you can remind them that they're expected to maintain confidentiality about the company's operations and results. You may consider reinforcing the expectation by having directors periodically sign a nondisclosure agreement.

Insufficient time to go through the formalities of having a board

Having a board does require certain formalities—like preparing meeting agendas and materials, and recording minutes. And yes, these activities take time. Hopefully, your board brings value so that your time investment pays off. Even the more-mundane activities of maintaining a board can have intrinsic value. For example, if certain family members someday allege that the company was not being run properly, having copies of meeting materials and minutes can help demonstrate that there was appropriate board oversight.

It's expensive

Governance usually costs more as you formalize processes and add directors. If cash flow is a problem, you could consider equity-like vehicles for director compensation. Regardless of how you choose to compensate directors, you should regularly assess whether they are bringing the value you need. If not, you can replace them.

What can you expect your board to do?

Boards of private family enterprises have more flexibility in the roles they play than public company boards. Why? Because they're not bound by the listing rules of stock exchanges and the Securities and Exchange Commission, which set responsibilities for public company boards and board committees.[3] Directors on private company boards do, however, have legal duties of care and loyalty.[4]

There are certain standard responsibilities that boards typically have. Understanding them can help you better consider which responsibilities you want your board to take on. The owners of a family enterprise may decide they don't want the board involved in all areas. For example, the founder's strategic vision may be so strong that he or she doesn't want additional input. That said, enterprises have failed when they've missed the implications of a changing enterprise or strategic environment, or were unsuccessful in their expansion efforts. And so it's worthwhile for whoever is running a family enterprise to consider getting input in the following areas before reaching major decisions.

Corporate strategy

Most executives believe that management should be responsible for developing the enterprise strategy and discussing it with the board. During such discussions, directors can draw on their experience and expertise to evaluate the plans and the appropriateness of underlying assumptions. Often, the discussion will result in some changes to the strategy that was initially presented. Once management and the board agree on a strategy, the board can then approve it and (in many cases) may also approve the budget needed to implement the strategy.

Company performance

How does the board know that management is executing the approved strategy effectively? By asking management to identify and set targets for key performance indicators that can be used to check on progress. The board then monitors performance and discusses what remediation may be needed if performance falls short.

CEO evaluation, compensation, and succession

No CEO knows everything—even if he or she founded or "grew up" in the enterprise. For example, a founder who is a technology or service innovator may not fully understand all the financing options for growing the enterprise to the next level. Or a CEO who has developed a concept largely alone might not know how to build an effective team. An important role for private enterprise directors can be to coach the CEO. That could include acting as a sounding board, helping the CEO manage through an issue, or having difficult conversations.

3 For a complete discussion of regulatory requirements, see PwC's publication *Governance for Companies Going Public—What Works Best*

4 For more information on board director duties, see *Building or Renewing Your Board* in PwC's Family Business Corporate Governance Series.

When family issues overlap with company issues, they can distract management and the board.

The reality is that founders or controlling shareholders who are CEOs usually determine their own compensation. But boards can be helpful in establishing performance targets and pay levels for CEOs who are family members or professional managers. When a family member is the CEO, a good board can provide guidance and perspective about the appropriate level of compensation. And when the time comes to replace the CEO, whether planned or unplanned, the board will participate in hiring a new leader.[5]

Risk management

An enterprise might face risks as varied as new competitors, emerging regulations, unreliable IT systems, losing key people, or business continuity (e.g., the impact of severe weather or other natural disasters on operations or the supply chain). Directors can provide feedback on whether managers are identifying the relevant risks and addressing them effectively.

It's often difficult to determine how much risk an enterprise should take. For example, should it take on more debt to finance expansion into new territories, or should it delay that expansion until it can self-finance? Should the enterprise invest more in a product line that already accounts for a large part of its income, or should it expand to other products to help spread risk? There is no single correct answer to such questions, but directors can help executives determine the appropriate level of risk.

Significant investments and transformational transactions

Significant investments (e.g., purchasing a major product line, building a new plant, or establishing a strategic relationship) and transformational transactions (e.g., mergers, acquisitions, or divestitures) don't always pay off as initially expected. Directors can ask questions to help ensure that management focuses carefully on the expected costs and returns of a proposed transaction, and whether it fits with the enterprise's strategy.

Compliance with legal and ethical standards, the company's "tone at the top," and the company's impact on its community

There seems to be a clear link between long-term, sustainable performance and an enterprise's behavior toward shareholders, customers, employees, and the communities where it operates. That's why many boards monitor the enterprise's moral compass. How? Partly by ensuring that the leader is setting the right tone at the top. A board can also help ensure the continuity of the enterprise's culture and brand through succeeding family generations and leadership transitions and through community involvement.

External communications

The board can play an important role in ensuring that the information—whether favorable or unfavorable—the enterprise communicates about its performance is accurate, relevant, and timely. That includes overseeing the reliability of financial information that goes to the family, other shareholders, creditors, and any regulators or other authorities.

Board dynamics

Bringing the right people together is the first step to creating an effective board. What else is needed?

- An appropriate board structure, possibly including committees

5 For more on succession planning, please see chapter 6 of this guide, as well as the publication *CEO Succession Planning* in PwC's Family Business Corporate Governance Series.

- Enough meeting time to allow the board to carry out all of its responsibilities
- The right information to support board decision-making
- An environment that encourages candid discussions and healthy debate

Some boards gauge their effectiveness by periodically assessing their own performance. Family company boards may face even more challenges than other enterprises in ensuring that they have effective board dynamics. Why? Because sometimes family issues become intertwined with company issues. When the two overlap, they can distract management and the board.

Questions to consider

- Is our current approach to governance working for us right now? Do we expect it will be appropriate given anticipated changes to the enterprise or the stakeholder base in the near future?
- If we change our approach to governance, what should we do and how should we get there?
- What, if any, additional responsibilities should our board assume?
- Do we have directors with the right knowledge and skills?
- Would adding outside directors enhance board effectiveness?
- Do we need to implement or update a policy on how we determine which family members serve on the board?
- Do our directors understand their fiduciary duties?

Conclusion

As a family enterprise grows, it's prudent to rethink board composition and structure in light of the enterprise's current needs. The right corporate governance model can add value by helping to separate the needs of the enterprise from those of the family, bringing in additional perspectives, broadening the CEO's vision, increasing accountability, and managing risk—all while keeping the family enterprise's culture and legacy in focus.

Choosing a more formal governance is not an all-or-nothing proposition, and families have the flexibility to choose and then later change their board type to best suit their current situation. Navigating the complex issues associated with changes to governance should involve consultation with trusted advisors who have relevant experience and expertise. The framework outlined here for evolving governance should serve as a starting point for robust dialogue, effective planning, and ensuring the family enterprise's continued success.

Chapter 6

Business succession

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, with potentially adverse effects on both the near-term and long-term health of the company. On the other hand, a clearly communicated succession plan can help assure stakeholders that the business is here to stay.

There are certain basic but critical steps that should be taken to help ensure the successful transfer of a business.

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 ignore this inevitability. As a result, they don't develop a business succession plan.[1]

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 assume their predecessor's level of responsibility. 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 practical (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 more limited.

1 Just 23% of US family businesses say they have a robust and documented succession plan: *US Family Business Survey*, PwC, 2016.

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 adjust 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 truly feasible. If 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 realistic goal, the owner will improve the odds of achieving it by taking the following steps.

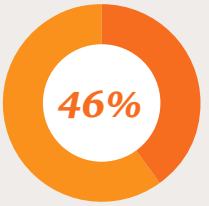
Establish business policies for family members and define a common purpose

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, requiring a balance of goals and priorities.

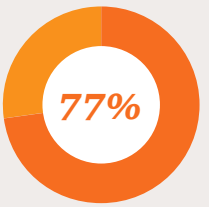
If only some family members are involved in running the business, the owner may

Sticky baton syndrome

Affecting family business leaders across the US



are hesitant to relinquish control to the next generation



do not have a robust documented succession plan for senior roles

Source: *Family Business Survey,* PwC, 2016

Q18c. Do you think it will be difficult to fully let go when the next generation takes over the business?

Q14B. Do you have a robust, documented, and communicated succession plan?

Percentages reflect the number of US survey participants who responded yes to these questions.

Ideally, succession decisions draw on recommendations from key stakeholders.

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's commensurate with the fair value of their services while still maintaining the equity interests of the nonparticipating family members. The business can then make periodic dividend distributions in an effort to allow all equity holders to enjoy the fruits of the business.

For businesses that are organized as flow-through entities for tax purposes, 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.

With potentially conflicting interests between participating and nonparticipating family members, it becomes essential to establish a shared purpose among all members. This will help unite the family inside and outside the business. Shareholder retreats and/or family gatherings can be forums for instilling the values of the business in younger generations, as well as in nonparticipating shareholders. A positive legacy can also be cultivated through how the company interacts with customers, employees, and the community.

Identify a successor

To help provide certainty that the business will survive beyond its current ownership, the individuals 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 if they lack the necessary 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. If 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.

Life cycle of a family business

Planning is key

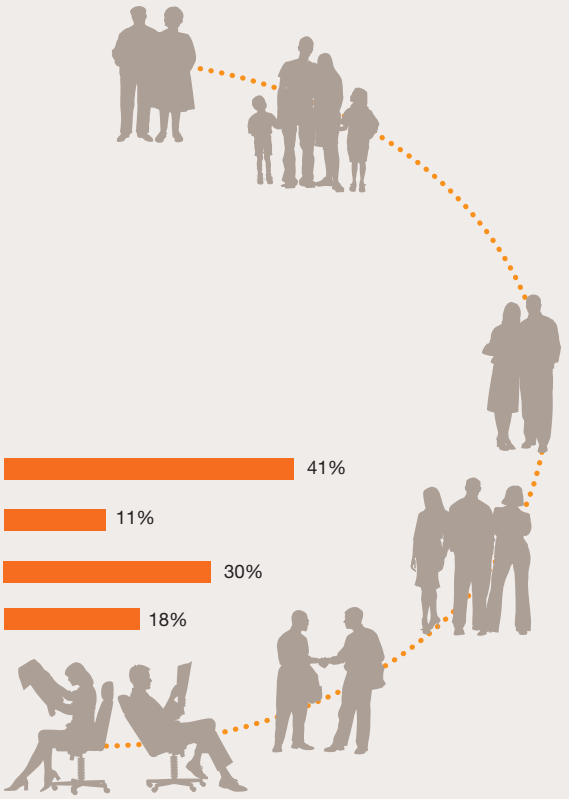
A successful transition almost always hinges on a well-constructed, written plan that clearly specifies the disposition of ownership interests in the business.

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

17% of US family businesses say they anticipate an ownership change within five years or so.

What sort of changes do they anticipate?



Source: *Family Business Survey,* PwC, 2016

Q15a: Do you anticipate any change in the ownership of your business over the next five years or so?

Q15bi: What sort of changes do you anticipate in the next five years or so?

Percentages reflect responses from US participants only.

Many factors should be considered in deciding what is the most appropriate structure for a particular family's business.

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 credibility 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. The board and key management can also be instrumental in supporting and training the successor.

It is also a good idea to encourage key employees both to broaden their overall skill sets and develop certain specialized skills to help sustain and grow the business. To this end, it may be necessary to recruit new managers with particular skills (e.g., people with emerging-markets know-how and skills in new technologies). This can prove difficult for some family businesses. Nearly 40% of the US participants in PwC's biennial global family business survey (2016) 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.

Determine appropriate business structure and reassess periodically

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

Family businesses can be organized in a variety of ways. 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 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 raise capital for the business, protect the business's assets from creditors, limit owner liability, and preserve and transfer wealth to successive generations.

Broadening horizons

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 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.

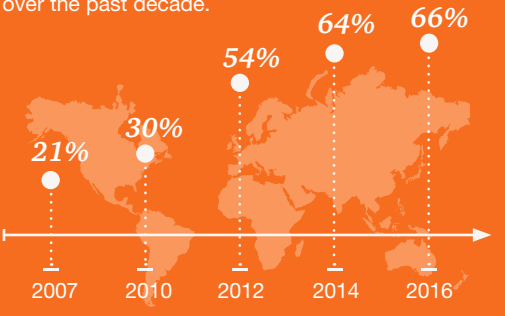
Faced with this new breed of competitor, leaders of family enterprises are finding that business as usual won't suffice. To maintain market share, they'll need to differentiate themselves from the competition by creating new products/services, improving current offerings, and finding new ways to reach 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 reduced 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.

The percentage of US family businesses planning to sell abroad has risen steadily over the past decade.



Source: *Family Business Survey*, PwC, 2016

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?
- Does the business expect to retain most of its earnings, or will it distribute them?
- Do the owners plan for any income, expense, or credit allocations?
- 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 accounting methods are appropriate or desired for the business?
- 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 business generally prefers to adopt a structure that will allow the business to avoid tax at two levels—the entity level and the ownership level. To avoid entity-level tax, many businesses choose a flow-through structure, such as an S corporation, partnership, 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 rigid shareholder requirements of an S corporation can become problematic as the family grows.

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 some cases, it might make sense to consider switching to an alternative ownership structure, such as a C corporation.

Recent tax changes are another reason a family business may consider an alternative ownership structure. For instance, a family business may find that the usefulness of the flow-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. (And given the political changes resulting from the 2016 election season, it's smart to keep abreast of any new tax regulations and be ready to react to changes.)

A successful transition almost always hinges on a well-considered, written plan.

Then too, some family businesses may opt to be structured as limited liability companies rather than as corporations. LLCs provide the benefit of limited liability for the owners, accompanied by much of the flexibility provided by partnerships. As with partnerships, LLCs allow for the flow-through of losses to the owners.

Before choosing a structure, a family business should first discuss with experienced advisors the 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 instead, 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 is 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 and other important issues now, and then revisiting them as circumstances change, should 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.

Business ownership agreements (buy-sell agreement)

Business owners frequently use trust agreements to protect their personal wealth. They may also find it prudent to use business contracts to address shareholder rights and potential business issues. Certainly, every business with more than one owner should consider using an owners' agreement—sometimes referred to as a business continuity agreement—to describe the terms and process for an orderly transfer of ownership interests. An agreement of this kind may cover a range of possible, predictable, and unanticipated events, such as an owner's potential disability, divorce, retirement, bankruptcy, premature death, sale of ownership stake, or dispute with other owners. If such a contractual agreement calls for a transfer of shares, generally one of two techniques is used to facilitate the transfer: a redemption-type agreement or a cross-purchase-type agreement. Occasionally a hybrid of these two is used.

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

In a cross-purchase arrangement, a 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 tax upon subsequent sale of the ownership interests.

In many cases, neither the entity nor the other owners have enough cash to purchase all business interests that are offered for sale. Life insurance is sometimes acquired on the owners' lives and can be owned by the business to assist in the redemption of a 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.[2] For other transfers (those not resulting from an owner's death), the owners' agreement might specify an installment payment plan that aligns with the cash-flow needs of the business. All good ownership plans should also establish a method for periodic valuations.

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 also a critical consideration. A business owner who is considering selling the business may want to time the completion of the sale for maximum tax advantage. Doing so could result in net after-tax proceeds that are substantially higher than if the deal were accelerated or delayed.

To manage such 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.

2 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.

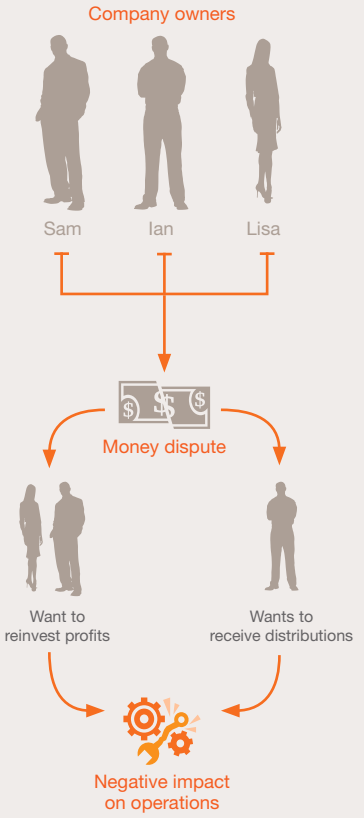
Business ownership agreement

Put one in writing to help avoid family disputes

Sam, Ian, and Lisa are siblings who own an S corporation; each holding one-third of the company's stock. Sam and Lisa work for the company and receive a salary; Ian does not.

For the past 13 years, the company has been very successful, in part due to the siblings' reinvestment of the company's profits in the business. Recently, however, conflicts have arisen due to Ian's desire to receive distributions. Sam and Lisa don't need the additional cash flow and oppose making distributions. The dispute begins to impact daily operations of the company.

Unfortunately, the siblings never executed a business ownership agreement to address how such disputes should be resolved. Sam and Lisa finally end up buying out Ian's share in the company, resulting in an expensive restructuring of the business. The siblings could have reached a less costly resolution had a business ownership agreement been in place.



A business that goes public must be ready to meet shareholder, regulatory, and market expectations from the start.

Initial public offering (IPO)

If a privately held family business wants to become publicly traded, its objectives may include accessing capital markets to raise funds, acquiring other publicly traded companies, attracting and retaining talented employees, diversifying and reducing investor holdings, or providing liquidity for shareholders.

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

Fulfilling those expectations will be an ongoing responsibility throughout the life of the company. Part of this 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. Likewise, a family business owner might find it difficult to share decision-making if he or she has been accustomed to making all of the decisions for the business. Thinking through these 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 an interest stream 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 and 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 ways 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 next 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.

Overview comparison of entities

	Partnership	S corporation	C corporation	LLC
Liability	Unlimited for general partners	Limited to amounts invested and loaned	Limited to amounts invested and loaned	Limited to amounts invested and loaned
Double taxation	No	No (except for some built-in gains and passive income)	Yes	No
Flow-through of profits and losses	Yes	Yes	No	Yes
Limitation on entity losses deductible by owners	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
Subject to passive activity loss rules	Yes	Yes	Only certain small C corporations	Yes
Tax rates	Income taxed to owners at marginal tax rates, plus 3.8% on investment income*	Income taxed to owners at marginal tax rates, plus 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 3.8% on investment income*
Special allocations	Possible, if there's a substantial economic effect	No	Possible, if tracking stock is issued	Possible, if there's a substantial economic effect
Fiscal year	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
Tax-free fringe benefits to owners	Limited	Limited	Permitted	Limited
Public offering	Yes, but with some complexity	No	Yes	Yes, but with some complexity
Tax-free merger with corporations	Yes, under certain circumstances; additionally, possible tax-free incorporation available	Yes	Yes	Yes, under certain circumstances; additionally, possible tax-free incorporation available
Accumulated earnings tax	No	No	Yes	No
Personal holding company tax	No	No	Yes	No

* The additional 3.8% tax applies to the lesser of net investment income or modified adjusted gross income that exceeds $250,000 for married couples filing jointly, $125,000 for married couples filing separately, and $200,000 for individuals.

Conclusion

The successful transfer of a family business is never a purely organic process. It requires a series of intentional and well-coordinated planning efforts, sustained over time. That's because leadership or ownership succession isn't a one-time event. It affects the continuity of the business and should therefore be approached with care and considerable forethought. Doing so will increase the likelihood that the business will thrive well beyond a leadership transition or ownership change, delivering lasting value to the family and other key stakeholders for generations.

Chapter 7

Family offices

The financial, managerial, and administrative needs of high-net-worth families can be extensive.

Increasingly, high-net-worth families rely on family offices to coordinate the many various aspects of their wealth management. Complex tax issues, global holdings, trusts—a family office can take responsibility for these, as well as run foundations and oversee other legacy-building endeavors. Of course, not everybody needs so broad a range of services. The duties of a family office can be expansive or more limited, depending on your specific needs.

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

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

Although they may have numerous professional qualifications, your advisors' most impactful 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 goals.

Personal recommendations from trusted sources make for a good starting point, but it's important to also do your due diligence. Analyze the potential hiring of a new advisor as carefully as you would make any other major business decision.

A well-coordinated advisory team, coupled with a family office, frees up family members' time so that they can focus on the family business.

- Review each 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
- Understand the range of services the advisor provides
- Make sure the investment advisor's investment goals are compatible with yours and that the advisor has a clear strategy in place to help you implement them, taking into account your risk tolerance and time horizon
- Ask critical questions, including how the advisor is paid for services, and whether they are willing to collaborate with your other service providers
- Assess an investment 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, 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 broad view of your wealth management plan, and proactively address potential adjustments
- Make sure the wealth management plan is well documented and that each advisor understands how his or her particular area fits within the overall plan
- 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, 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, LLCs, 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.

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 changing 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

Managing the complexities of family wealth

As family wealth grows and the business environment becomes more complex, families need to handle more intricate issues around global tax, risk, technology, and data security.

Globalization

- Professional managers and advisors help manage global family wealth and affairs.
- Business and investment entities are expanding and diversifying globally.

Professional affiliations

- Families are seeking networks so that they do not have to "go it alone."
- Family office associations improve collaboration for advisors of wealthy families.

Charitable giving

- High tax rates and corporate social responsibility are resulting in advanced philanthropic structures and activities.
- Charitable giving strategies and wealth transfer objectives need to be synchronized.

Institutionalization

- Families are organizing and formalizing activities into a family-office-type environment.
- Standard industry practices and controls are incorporated into family office management.

Technology

- There is a stronger desire for mobile/digital information.
- Concerns around data integrity, cyber security and disaster recovery are increasing.

Generational shift

- The personal values of the younger generation may not coincide with those of older family members.
- Generational wealth transfer creates challenges.

Managing external relationships

- Increased outsourcing to service providers requires due diligence, oversight, and management.
- Financial controls, risk management, and transparency into data and transactions are increasingly important.

asset management or perhaps even run 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 and portfolio management
- Manager selection and monitoring
- Timely performance review and rebalancing
- Investment research and strategic analysis
- Risk assessment and review

Asset consolidation

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

Tax, legal, and financial services

- Personal and entity level
- Retirement, education, and insurance planning
- Income tax planning and compliance (domestic and international)
- Cash flow and debt management
- Gift and estate planning
- Entity structuring

Philanthropy

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

Family legacy

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

Administrative services

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

Other services

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

A centralized approach

How a family office brings the big picture into focus

Elizabeth created and has managed a very successful business for many years. When her four children reach adulthood, she transfers a portion of the business to them and to trusts for their families.

Elizabeth establishes a family office to coordinate advisors' efforts and manage the finances and activities of her family.

After decades of running and growing the business, Elizabeth decides to sell it so that she can pursue a new personal interest—international travel.

Until selling the business, Elizabeth owned few significant, investable liquid assets. That has changed as a result of the sale. Elizabeth has neither the time nor the expertise to manage her new liquid assets. She is also concerned about how her affairs will be managed when she is away from home, and the tax implications of her travels and her family's current residence overseas.

Elizabeth has various advisors. They include a tax accountant, an investment advisor, an estate planning attorney, and an insurance advisor. However, Elizabeth feels that there is insufficient coordination among them and that they lack a complete understanding of her overall situation.

After consulting with trusted friends and advisors, Elizabeth decides to establish a family office to coordinate the work of her various advisors so that they function as a cohesive team.

In addition to the improved coordination, the family office also manages Elizabeth's personal finances, the family's cash flow, the activities of her advisors, and her ongoing estate planning. With this centralized approach, Elizabeth feels that she and her family are well covered.

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.

Typically, the lead family members and a key outside advisor work together to decide the main objectives of the family office. Those objectives will dictate which services the family 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 family office's initial funding, anticipated operational costs, and allocation of costs among family members. Other key decisions concern the size and location of the family office, who will run it, and how it will keep the family informed of the office's 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. It also 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 have somewhat fewer resources. 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 their 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 service models.

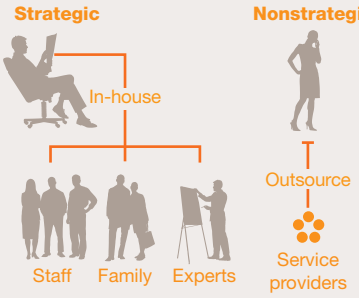
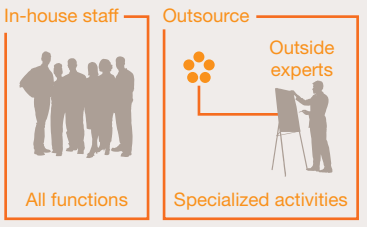
Ongoing operations

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

Family office models—which one to choose?

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

Mutual trust is critical to ensuring the right tone and direction of the family office as it addresses the needs of family members.

(both short and long term) and then routinely reviewing them. At a minimum, a family should meet annually 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.

Enhanced oversight

Many families use trusts as vehicles to accomplish estate-tax savings and to provide governance of the assets and protection from creditors. In many cases, a trust can also allow for educating and coaching subsequent generations about wealth management and stewardship. Oftentimes, when trusts are created, the creator of the trust appoints himself or herself, a trusted family friend, or an advisor as the trustee. In many cases, this arrangement functions well and serves the family's desire for privacy. However, as time passes and generations age and pass away, the family faces the situation where the advisor or friend can no longer serve as trustee. In some cases, the number of trusts has grown and increased the demands on the trustees.

An increasingly common avenue families explore to resolve the trustee issue is to form a private trust company (PTC). Although not a new mechanism for governing trusts, PTCs have seen a revival of sorts as a result of some favorable state laws governing their operations. A PTC provides centralized trustee management, which imposes a common administrative and decision-making framework for all trusts. PTCs can be perpetual and flexible in nature and alleviate trustee succession issues. A PTC can be designed and operated so that it fosters family involvement and wealth education. By removing the children and grandchildren as sole trustees, it prevents undue influence on those potential heirs, be it pressure from friends, colleagues, creditors, and random investment requests. The PTC is managed by a board of directors who govern using formalized rules and business standards. This structure also can create a welcome environment to attract the top talent discussed earlier.

In some cases the family office becomes a part of the PTC, which can help to streamline operations of the family office, as well as its investment decisions. In other cases, the family office remains separate from the PTC. In cases where the PTC is a separate entity, there is usually a formal agreement between the PTC, entities, and family members served by the family office regarding the specific terms of service.

Unless the family organizational structure includes trusts, a PTC is not relevant. However, with the ever-increasing popularity of trusts, a PTC can be a powerful tool to enhance the family office's ability to manage wealth.

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. 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.

Mutual trust is critical to ensuring the right tone and direction of the family office as it addresses the needs of 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. A mission statement can help in this regard by clarifying roles and responsibilities, guiding parties within the family office, and 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 every generation of the families it serves—including those who 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 specific area of 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 information and 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 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. Because a family office focuses on multigenerational wealth transfers, it readily assesses possible strategies such as annual 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 businesses 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. With miscellaneous itemized deductions, because

Family offices in the United States tend to be as versatile as families are varied.

only those expenses that are over 2% of adjusted gross income may be deductible, many high-net-worth taxpayers will receive no tax benefit for such amounts (e.g., accountant and attorney fees). Above-the-line deductions, on the other hand, do not come under this limitation and therefore present a tax-savings opportunity. Family offices that support a family business may also be able to pursue opportunities to set up tax-deferred retirement plans.

Other areas of focus

Family offices have a number of areas of interest. Several of the key areas (tax, technological, advisor coordination, and generational wealth planning) have already been addressed in this chapter. Other areas of focus include:

- Establishing and monitoring internal controls in order to determine what information needs protection; who has authorization to complete transactions, such as authorizing wire transfers; and what systems are used and what procedures are in place for those users.
- Family offices are often an integral part of a family's philanthropic plan. A family office may assist with determining which philanthropic vehicle to use—direct support, a private foundation, and/or a donor-advised fund. If a family has a foundation, there are several important aspects with which a family office may be involved. For example, all foundation activity must be accounted for separately from the family office activity. Also, the family office often monitors the use of foundation funds to be sure they are used only for permitted foundation activities.
- Support and coordination for state residency changes are often managed by the family office. When a high-net-worth individual changes his or her state of residency, the family office typically assists with several of the administrative functions related to the relocation, which can serve as documentation for the change in domicile should the individual ever be audited regarding the residency change.

Conclusion

While every family is different, the mission of all family offices is nearly always identical: 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—will ultimately determine how best to tailor a family office's structure and function to a particular family's circumstances. Indeed, family offices in the United States tend to be as versatile as families are varied.

Chapter 8

Cross-border tax considerations

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 all 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 to a US taxpayer,[1] they could entail unforeseen complexities in tax consequences and reporting (even if such investments and transactions are standard in the countries where they occur). 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 non-US-citizen spouses will have special issues of their own to address. There are also special considerations when individuals immigrate to, invest in, 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 comply with tax rules efficiently. While we deal here with the US rules, it is also important to consider the rules of the non-US jurisdiction where the investments are located.

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

The US tax regime is unique in that it taxes US citizens on their worldwide income.

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 might also be taxed in the foreign jurisdiction.

The US tax regime is unique in that it taxes US citizens on their worldwide income. 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 nationals 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 national meets the "physical presence" test and no tax treaty[2] relief is available or claimed, the foreign national 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 for other reasons (e.g., with a vacation in Florida). In such cases, if the foreign national exceeds the number of days that he or she is allowed to remain in the US while still retaining nonresident status 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 nationals who are aware of these rules before accepting a short-term assignment can take steps to avoid attaining US tax resident status or else engage in tax planning that would lessen the tax impact of attaining that status.

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

Nonresidents

Like many other 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 countries and the United States. Tax treaties often have provisions that permit certain types of income to be excluded from US taxation, to avoid double taxation, or that subject the income to lower tax rates.

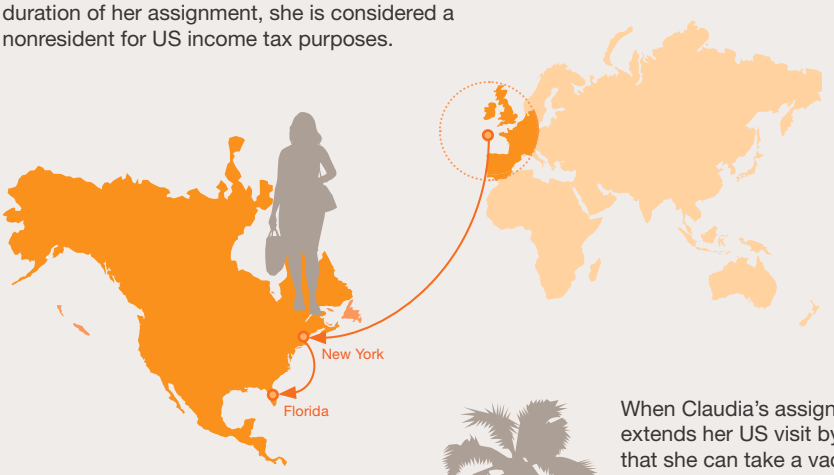
Some types of US-sourced income (e.g., dividends from US corporations) are subject to US tax withholding, which in most cases means that a nonresident taxpayer may fully satisfy his or her US tax obligations vis-à-vis such income without having to file a US tax return.

2 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 resident

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

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



When Claudia'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, Claudia inadvertently becomes a US resident.

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

Claudia 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 Claudia might lessen the tax effect of her new residency status.

Relief from double taxation is not necessarily available at the state level.

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 subject to double taxation. The most common form of relief is the foreign tax credit. If certain conditions are met, the foreign tax credit provides 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.

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 $101,300 (for 2016) 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 pairing the earned income exclusion with foreign tax credits. Qualified tax advisors can run projections to determine the most tax-efficient approach.

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 the tax years 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.

Foreign jurisdictions are often on a different tax calendar, or have different due dates for tax payments, increasing the likelihood of mismatches. The rules for taking 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 crucial 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 every country. It does, however, have negotiated tax treaties with many 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 necessarily available at the state level.

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 file). In addition, the US income tax regime has complex anti-deferral rules that can prevent

investors from receiving 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.

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 may not be subject to US income tax (unless the corporation is earning US-sourced income). Therefore, the income earned in the foreign corporation may be deferred from being taxed by the US tax authorities.

To prevent US taxpayers from incorporating overseas in order to defer income tax to a later year, Congress developed anti-deferral rules many years ago, applicable to controlled foreign corporations and certain other 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 controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs). A foreign corporation that is owned more than 50% by US shareholders[3] is classified as a CFC. PFICs do not have a minimum ownership requirement; instead, a PFIC is a foreign corporation that meets one of two tests: 75% or more of its income is from passive sources, or at least 50% of its assets are held for the production of passive income. Keep in mind that certain seemingly innocuous investments, such as foreign mutual funds, may be treated as PFICs. Furthermore, ownership of a CFC or PFIC can result in considerable information reporting requirements. Beware of the attribution rules where a taxpayer may be deemed to own a higher percentage of a foreign entity due to ownership of other family members, including nonresident aliens. The CFC and PFIC rules are very complex, so it is strongly recommended that you seek appropriate counsel when navigating these rules.

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

Foreign currency exchange gain or loss

Investing directly in foreign currency is another investment strategy that some taxpayers employ. In recent years, the currency markets have seen extensive volatility, creating 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.

For purposes of the US income tax, gains and losses realized on currency transactions are not typically treated as capital transactions that are subject to preferential capital gains tax rates.

3 The term 'US shareholder' is defined as a US person that owns directly, indirectly, or constructively 10% or more of the total combined voting power of the foreign corporation at any time during the taxable year.

It is critical that a US taxpayer be aware of both the benefits and the pitfalls of investing in foreign currency.

Instead, they are generally 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, but also the pitfalls of these types of investments.

Recently, virtual currency has been a popular topic. Virtual currency is digital money with real currency value and is accepted as a means of payment by certain persons or institutions. A common type of convertible virtual currency is Bitcoin. Bitcoin can be digitally traded for US dollars or other non-US currencies. For US tax purposes, under current law, the exchange of this convertible virtual currency is considered the exchange of property, and not the exchange of currency. Whether the exchange of virtual currency is considered a capital gain or loss or an ordinary gain or loss depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

If the virtual currency is a capital asset to the taxpayer, then the taxpayer will realize a capital gain or loss on its disposition. If the virtual currency is not a capital asset, such as an item of inventory, then the taxpayer will realize an ordinary gain or loss on disposition. The tax treatment of the exchange of virtual currency and the relevant foreign disclosure requirements associated with owning virtual currency are complex and relatively new. Making your tax advisor aware of investments or transactions in virtual currency is imperative to make sure that the tax reporting associated with virtual currency is complete.

Foreign trusts and estates

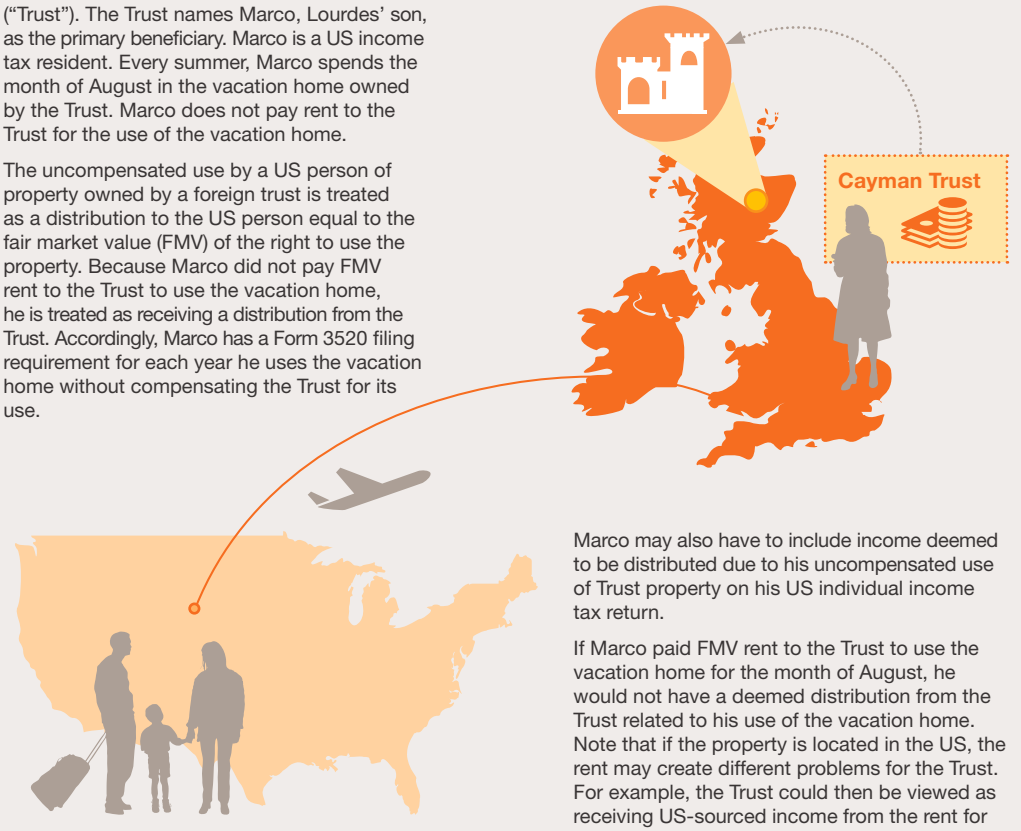
US taxpayers who establish or are beneficiaries of foreign trusts may face unanticipated tax consequences and significant reporting obligations. A US taxpayer who creates a foreign trust over which he or she has no control may nevertheless continue to be subject to tax on all income and gains on the 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 income tax purposes.

Beneficiaries who receive distributions from foreign nongrantor trusts are required to disclose and report distributions for the year of receipt. In addition, the use of foreign trust property may result in a taxable event to US taxpayers. 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. Bequests from a foreign estate are generally not taxable (see the exception discussed in the expatriation section later in this chapter) but may still require disclosure.

Uncompensated use of trust property

Lourdes, a non-US citizen and non-US resident for US income and transfer tax purposes, transfers a vacation home into a non-US trust ("Trust"). The Trust names Marco, Lourdes' son, as the primary beneficiary. Marco is a US income tax resident. Every summer, Marco spends the month of August in the vacation home owned by the Trust. Marco does not pay rent to the Trust for the use of the vacation home.

The uncompensated use by a US person of property owned by a foreign trust is treated as a distribution to the US person equal to the fair market value (FMV) of the right to use the property. Because Marco did not pay FMV rent to the Trust to use the vacation home, he is treated as receiving a distribution from the Trust. Accordingly, Marco has a Form 3520 filing requirement for each year he uses the vacation home without compensating the Trust for its use.



Marco may also have to include income deemed to be distributed due to his uncompensated use of Trust property on his US individual income tax return.

If Marco paid FMV rent to the Trust to use the vacation home for the month of August, he would not have a deemed distribution from the Trust related to his use of the vacation home. Note that if the property is located in the US, the rent may create different problems for the Trust. For example, the Trust could then be viewed as receiving US-sourced income from the rent for the use of US property.

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.

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, with no cash or other property received in exchange, 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, estates, or trusts usually result in the recognition of gain for income tax purposes. In particular, when a person who has been subject to US tax on the income of a trust leaves the US, unintended tax consequences may result.

Receipt of gifts or bequests from non-US persons or entities

A US person who receives gifts from foreign persons or entities may have to report the receipt of such gifts. A US taxpayer must report gifts from nonresident individuals or foreign estates to the extent the money or other property received in a calendar year is valued at more than $100,000. To calculate the threshold amount, a US taxpayer must aggregate gifts from different nonresident individuals and foreign estates if the US taxpayer knows (or has reason to think) that those persons are related. A gift to a US taxpayer does not include amounts paid for qualified tuition or medical payments made on behalf of the US taxpayer when paid directly to the provider.

A US taxpayer is also required to report gifts of cash or property valued at more than $15,671 (in 2016) from foreign corporations or foreign partnerships. Unlike the threshold to report gifts from nonresident individuals and foreign estates, the threshold to report gifts from foreign corporations or foreign partnerships is indexed for inflation.

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 when Congress enacted the Foreign Account Tax Compliance Act (FATCA). FATCA is a significant development in the US government's efforts to combat tax evasion, as it is intended to help the IRS 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 to that entity will be subject to a 30%

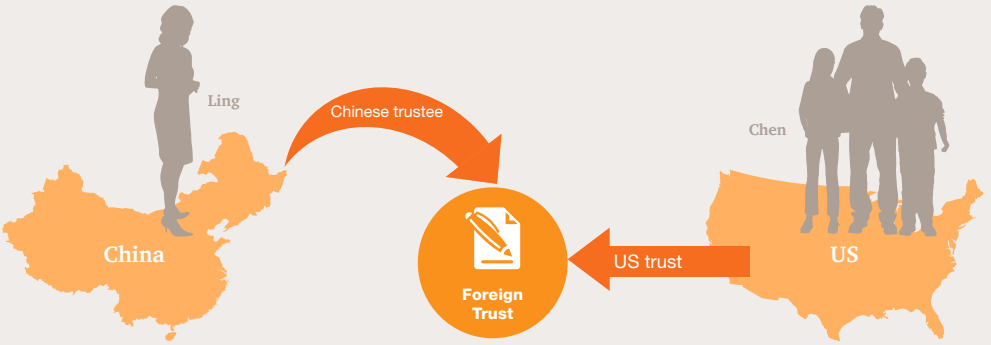
Unintended foreign trust

What you think is a US trust might turn out otherwise, depending on your trustee

Chen moves from China to the United States, becoming a US citizen in 2013. Shortly afterwards, he creates a living trust for the benefit of his two children, Xing and Shun.

Chen designates his sister Ling as the sole successor trustee. Chen dies in 2016. Because Ling is a Chinese national, however, Chen's trust becomes a foreign trust as soon as Ling takes over, which makes it subject to various foreign reporting requirements.

If Chen had appointed his successor trustee more carefully, he could have avoided this unanticipated reporting burden.



A trust is considered domestic for US tax purposes if a US court can exercise primary supervision over the trust's administration and one or more US citizens have the authority to control all substantial decisions regarding the trust.

One of the most typical offshore assets owned by individuals is a foreign bank account.

withholding tax. FATCA also implemented a new reporting requirement for owners of specified foreign financial assets (discussed later in this chapter).

Voluntary disclosure

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

OVDP resulted in significant revenue generated from back taxes, interest, and penalties. The IRS therefore proceeded to roll out another OVDP in 2011, and again in 2012, but with higher penalties than those under the 2009 program.

The latest Offshore Voluntary Disclosure Program (2014 OVDP) is based on the 2012 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 inaccuracy. The 2014 OVDP also announced a program known as the Streamlined Filing Compliance Procedures (streamlined procedures). The streamlined procedures allow for eligible taxpayers to come into compliance with the US federal laws without having to enter the OVDP. The streamlined procedures are available to both US resident and nonresident taxpayers who meet the eligibility requirements, which include being non-willful in their failure to report foreign income and accurately file US tax returns.

Eligible resident taxpayers are subject to a reduced penalty structure with respect to unreported foreign financial accounts. Eligible nonresident taxpayers are not subject to offshore penalties.

Taxpayers who have failed to file one or more required international information returns, but who do not need to use the 2014 OVDP or streamlined procedures to file delinquent or amended tax returns to report and pay additional tax, may submit these additional reporting forms through the Delinquent International Information Return Submission Procedures. Taxpayers who are eligible to submit any delinquent reporting forms through this method may file the delinquent information returns with a statement of all facts establishing reasonable cause for failure to file.

With the streamlined procedures and other foreign asset reporting methods, 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 obligations. This may encourage taxpayers with straight-forward issues to come forward and comply. Conversely, the IRS has significantly increased the penalties under the standard procedures of the 2014 OVDP.

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 FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR). In previous reporting years, this form was known as Form TD F 90-22.1 and was mailed to the Department of the

Treasury. Starting July 1, 2013, the Department's Financial Crimes Enforcement Network (FinCEN) began requiring that all reports be submitted electronically, whether they are for current or prior tax years.

In filing this form, 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 of all foreign accounts is greater than $10,000 at any point during the year). The definition of a foreign "account" for purposes of this report is very broad, and many investments that might not obviously need to be disclosed do in fact have to be reported.

Failure to file the FBAR can result in significant penalties. Unintentional violations that are not due to reasonable cause may result in a civil penalty not to exceed $10,000 per violation. For willful violations, the penalty may be the greater of $100,000 or 50% of the account's balance at the time of the violation, per violation. The Department of the Treasury treats each unreported account as a violation.

Starting in tax years after December 31, 2015, this form is due on April 15 with a six-month extension available (to October 15). This mirrors the due dates for individual income tax returns. A special automatic extension to June 15 is available for US citizens or residents whose tax homes are outside the United States (to align with the original due date of their income tax returns). This rule is also available for certain partnerships and corporations that keep books and records outside the United States, and for foreign corporations which maintain an office within the United States.

Foreign asset disclosure

After the enactment of FATCA, 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 (e.g., a rental contract, the cash value of life insurance, and pensions).

Starting for tax years after December 31, 2015, final regulations require certain domestic corporations, domestic partnerships, and domestic trusts to comply with the foreign asset disclosure filing. For domestic corporations and partnerships, two tests are required to be satisfied in order for the entity to be subject to filing: a "closely held" test and a "gross passive income" test (at least 50% of income is passive). For domestic trusts, the regulations look into the existence of current beneficiaries while providing exceptions to certain domestic and grantor trusts. The new regulations are complex and caution should be exercised when determining the filing requirement for these entities.

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

For US citizens, the reach of the US transfer tax system is fairly clear. The rules for noncitizens, however, are more complex.

Benchmark Survey of US Direct Investment Abroad (Form BE-10)

As of 2015, federal law requires all US persons owning or controlling, directly or indirectly, a 10% or greater voting interest in foreign business enterprises to file Form BE-10, *Benchmark Survey of US Direct Investment Abroad*, with the US Department of Commerce—Bureau of Economic Analysis. In previous years, the BE-10 was only required to be filed by survey recipients who were pre-selected by the Department of Commerce. As of 2015, however, this form is required to be filed by all US persons who own qualifying foreign interests. For this purpose, US persons include US individuals, estates, trusts, or business entities. Form BE-10 reports a combination of financial data and operational and ownership structure data to the Bureau of Economic Analysis for the purpose of compiling statistical reports regarding US ownership in foreign investments. The survey responses are confidential and cannot be used by the government for any other purpose. Form BE-10 is due every five years—mark your calendar for the next filing due date in 2020, relating to the 2019 reporting year.

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. Therefore, potentially all transfers of wealth are subject to US estate tax, gift tax, and generation-skipping transfer tax (collectively known as transfer taxes).[4]

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 is therefore, mainly a question of fact.

An individual will be considered domiciled in the United States if he or she lives in the US and intends to stay indefinitely. When assessing an individual's intent to remain permanently in the United States, there may be a variety of factors to consider, 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

4 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.

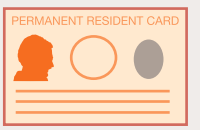
An individual will be considered domiciled in the United States if the person is living there and intends to stay indefinitely.

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.

The unlimited marital deduction does not apply to transfers to noncitizen spouses, including spouses holding green cards.

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 recipient per year (or $148,000, in the case of gifts given to a non-US-citizen spouse in 2016). Unlike US citizens and residents, nonresidents are not entitled to a lifetime gift tax exemption. However, for purposes of US estate tax, a reduced estate tax exemption of $60,000 is available for US situs assets.

The generation-skipping transfer (GST) tax is only applied to transfers by a nonresident to the extent the transferred asset is characterized as US situs property subject to the estate or gift tax, as the case may be.

Note that a nonresident's transfer of stock (an intangible asset) 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 relevant for many 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 or resident 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 $148,000 for transfers in 2016). For estate tax purposes, the marital deduction is denied unless the property is placed in a qualified domestic trust (QDOT).

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. A QDOT is the only way (aside from claiming treaty benefits) to claim a marital deduction on assets passing to a noncitizen spouse upon the death of the US-citizen or -resident 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 (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 other countries. Currently, the United States has a number of estate tax treaties in effect, providing rules that may mitigate the applicability and impact of the general rules that apply to the US estate tax on 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.[5]

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 can be significant.

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

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, while the charitable deduction for estate and gift tax purposes has no such limitation. Also, the amount of the deduction for estate and gift purposes does not differ based on the type of charitable organization or the type of property contributed (e.g., a public charity versus a private foundation), the way it does for income tax purposes.

Special considerations

Coming to the United States

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 with traditional income tax planning, where an individual who anticipates increasing tax rates may consider accelerating income to a year with lower tax rates, the same fundamental logic may hold true for nonresidents moving to the United States. A person immigrating to the US should consider accelerating the receipt of non-US income so as to cause recognition of such income during the non-residency period. Other strategies include deferral of losses and using life insurance to shield income from taxation. Examples of income that may be accelerated include compensation, pension income, rents, royalties, interest, dividends, and capital gains. The opposite approach may also be warranted if tax rates are anticipated to decrease upon arriving in the US. Special consideration should be given to how income is taxed in local jurisdictions, versus how it would be taxed in the US before embarking on such planning.

Estate planning for individuals coming to the US is influenced by many factors, including the objectives of wealth transfer, composition of assets, residency of family members, and whether US domicile is anticipated. Lifetime gifts and the creation of trusts may be appropriate prior to establishing US domicile, as an opportunity to minimize US estate and gift taxes and shift assets to the next generation. For example, gifts of non-US situs assets, or the creation of a trust with non-US situs assets, prior to establishing US domicile may escape US transfer taxes if structured properly.

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 order to minimize their US tax exposure.

Nonresident tax considerations

As noted earlier, nonresidents have some flexibility in the structuring of their US holdings in order to minimize their US tax exposure.

Real estate

The US income tax system contains numerous traps for the unwary foreign investor, especially in the area of real estate. With proper planning, a foreign investor should be able to minimize US

estate and gift taxation on US real estate, avoid or reduce withholding tax on gross investment income generated by the investment, minimize potential capital gain on the sale of an investment, and minimize the annual US income taxation on the net income generated by the investment.

Real estate is a tricky asset for planning, especially since US real estate is a US situs asset and the US generally has primary taxing rights of such property for income, gift, and estate tax purposes. There are various real estate ownership structures that should be considered prior to a nonresident individual purchasing real estate. These ownership structures include, but are not limited to, direct ownership by a foreigner, a US company, a foreign company, a combination of both, a US or foreign trust, or possibly a foreign partnership. No one structure fits all circumstances.

From an income tax perspective, rental income from US real estate is not considered income effectively connected with a US trade or business (which allows for US taxation on a net basis, accounting for operating and financing costs, as well as depreciation) unless a special election is made.

For the sale of US real estate, the US generally imposes a withholding tax of 15% on the sales proceeds (if the transaction is consummated after February 2016), and a reduced rate of 10% for certain sales of residential property. This withholding tax is meant to avoid non-compliance and often, it will exceed the actual capital gains tax charge and will require a US income tax return filing to reclaim overpaid tax. To avoid excess withholding, proper planning should be done in advance of the sale.

From an estate and gift tax perspective, there may be planning opportunities to alleviate the estate tax burden, but any potential estate tax savings must be weighed against 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 a treaty is in place, sales of such equities are not typically subject to capital gains tax. Such assets, however, are considered US situs property for estate tax purposes and therefore estate tax planning should be considered.

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 nonresident investors.
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.

Reporting obligations of nonresident aliens

Nonresident aliens with US income (described earlier) may be required to file Form 1040-NR, *US Nonresident Alien Income Tax Return*. Nonresident aliens are not required to file the additional informational forms required for CFCs and other foreign entities, however, these forms may be required if an individual is classified as a nonresident by way of an income tax treaty.

A common holding structure that foreign persons have deployed to own US assets, the single-member limited liability company, has been an area of focus for the IRS to strengthen information-sharing efforts with foreign tax authorities. In May 2016, the IRS released proposed regulations that would require foreign persons who wholly own US domestic disregarded entities (e.g., single-member limited liability companies) to annually file an informational return to disclose the identity of the foreign owner. Furthermore, this informational form would also disclose certain reportable transactions between the entity and its foreign owner. These proposed regulations, once finalized, will have a great impact on many nonresidents.

Leaving the United States

Expatriation

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

Although there are certain exemptions, the 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 should 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 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.

In addition to seeking immigration advice, **STOP** and seek tax advice prior to obtaining or relinquishing your green card.

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 intensified.

Chapter 9

Risk management

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

In recent years, local and global headlines have taught us to prepare for the unexpected. While many of us are unlikely to experience a disaster 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 consequential 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.

IRS identity theft and scams

Each year, a greater number of individuals are confronted with new fraudulent schemes by those intending to obtain money or personal information. The federal tax system is increasingly a target of these efforts. These attacks have been concentrated in two areas—first, filing fraudulent income tax returns to wrongfully claim refunds and second, obtaining personal information by impersonating IRS officials, either by phone or by e-mail. The personal information is then used to commit fraud or other crimes using the victim's name and Social Security number.

Fraudulent tax return filings

This technique involves filing a federal or state income tax return using falsified information. The false tax return is then processed by the Internal Revenue Service or state tax authorities and a refund is issued to the filer of the false return. Taxpayers usually are unaware of the identity theft until they receive a notice from the IRS or a call from their tax preparer. The following are indications that a false return has been filed:

- You attempt to electronically file the return and receive a notice that it is not accepted because someone else has filed using the same Social Security number. If you use a professional tax preparer, they will get the electronic failure notice and will then alert you to the problem.
- The IRS sends you a notice asking for additional information about your tax return when you have not yet filed.
- The IRS sends a notice indicating that it will not release a refund until you call a specific number and answer questions about yourself when you have not yet filed.

Typically these false returns are filed early in the filing season.

What to do—If you receive an IRS notice like those described above you should call the IRS Identity Protection Specialized Unit at 800-908-4490. The IRS specialty unit will block the false filing and put a hold on the tax account. You should complete IRS Form 14039, *Identity Theft Affidavit*, and file it along with copies of identity verification documents (driver's license or passport). The IRS also suggests filing a report with the local police, as well as contacting the fraud departments of the three major credit bureaus (Equifax, Experian, and TransUnion). Naturally, the proper tax return must be paper-filed, along with copies of Form 14039 and the identity verification document.

Telephone and e-mail phishing

This technique involves impersonating IRS officials on a telephone call or through e-mail correspondence. The contact typically begins with an aggressive assertion that taxes are due and that the call or e-mail is part of a collection effort. Many calls include a threat that police are on their way to the home. The objective is to startle the victim into revealing sensitive information such as Social Security numbers, bank account data, or credit card data. Some e-mails involve a link, attachment, or reply contact. Often the links or attachments will contain malware designed to extract sensitive information located on the computer's hard drive.

The IRS does not:

- Call about taxes without first mailing you an official notice (usually several)
- Demand that you pay taxes without the opportunity to question or appeal
- Require that you use a specific payment method for taxes (such as prepaid debit card)
- Ask for credit or debit card numbers over the phone
- Threaten you with arrest

What to do—If you have any questions about particular phone, e-mail, or letter correspondence from purported IRS agents, you should notify your tax preparer. Many preparers have significant experience with instances of identity theft and can provide helpful information regarding the legitimacy of the correspondence, as well as assist with any next steps.

Asset ownership

Protecting your property and other assets 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 help determine the degree to which they are at risk.

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)

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. Additionally, they are generally transferred to a surviving spouse outside of any probate proceeding. However, jointly held assets are often problematic for estate-planning purposes. When there is too much joint property, or only joint property, the result may be that estate-tax savings trusts (e.g., credit shelter trusts) created in testamentary documents cannot be funded. This has been less of an issue since estate tax rules were changed to allow portability of the federal estate tax exemptions between spouses for deaths after 2010.

Assets held in joint name with others

Assets held in joint name with others, with rights of survivorship, remain in the taxable estate of the original owner (i.e., are not deducted from the gross estate for tax purposes) but, as with marital joint property, do not go through the probate process. Assets held as tenants-in-common (i.e., each person owns a separate share of the property) are subject to the probate process and do not provide any asset protection. The asset, however, 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 can be useful 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. Remember, a revocable trust is effective only if assets are retitled to the name of the trust. Therefore it is important to retitle any assets placed in your revocable trust once it is established. The downside to a revocable trust is that assets titled in the name of the trust will still be considered your assets for estate tax purposes. Assets transferred to irrevocable trusts do not go through the probate process and, unlike revocable trusts, do provide liability protection and can provide significant estate-tax savings. Irrevocable trusts can take many forms and can be used to accomplish a variety of estate-planning goals. However, issues regarding gift tax and generation-skipping tax should be considered before assets are transferred into irrevocable trusts.

Self-settled asset protection trusts

Some states provide liability protection for self-settled asset protection trusts—also called domestic asset protection trusts (DAPTs). 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 but not available to creditors. 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). When they are given full protection, the states usually require the use of an in-state institutional trustee. Further, US bankruptcy law requires a waiting period for the asset-protection features.

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

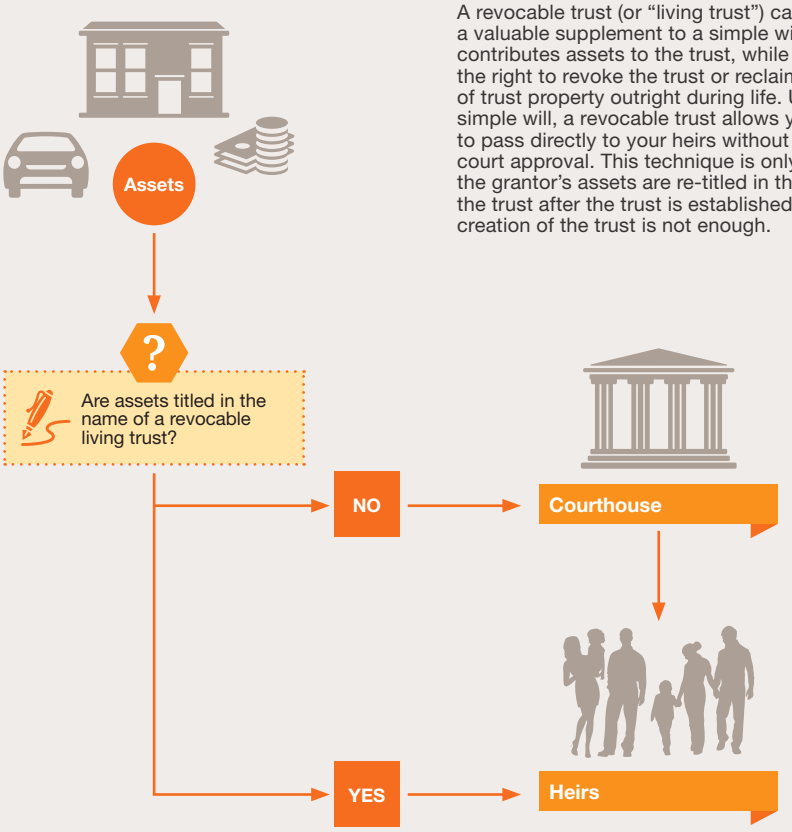
Offshore asset protection trusts

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 (e.g., Bermuda or the Cayman Islands). There are professional groups that specialize in advising people as to where to set up these trusts and how to structure them. Such arrangements can present various complications and fees. As with domestic asset protection trusts, the degree to which these offshore versions protect assets is a subject of debate in the legal community.

Offshore trusts come with a host of special tax filing requirements (e.g., Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and/or Form 3520-A, *Annual Information Return of Foreign Trust with a US Owner*). These requirements are imposed on the trustee, beneficiary, or trust creator.

Likewise, individuals with offshore financial accounts may also have to file Form 8938, *Statement of Specified Foreign Financial Assets* and/or FinCEN Form 114 (previously Form TD F 90-22.1), *Report of Foreign Bank and Financial Accounts* (FBAR). Please see chapter 8 for more information on these forms and the related penalties for not filing.

Preserve privacy—avoid public documents



A revocable trust (or "living trust") can serve as a valuable supplement to a simple will. A grantor contributes assets to the trust, while retaining the right to revoke the trust or reclaim ownership of trust property outright during life. Unlike a simple will, a revocable trust allows your assets to pass directly to your heirs without the need for court approval. This technique is only effective if the grantor's assets are re-titled in the name of the trust after the trust is established; the mere creation of the trust is not enough.

Advantages of a revocable living trust

- Trust assets are not subject to probate.
- Ensures the privacy of the decedent's estate and the surviving family members.
- Administrative fees associated with probate are avoided.
- Can avoid probate in each state where grantor owns real property.

Combining a LLC/LP with an irrevocable trust is considered a double form of asset protection and is popular with many financial advisors.

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 popular with many financial advisors.

In recent years, LLCs have gained popularity as a vehicle for privacy protection. A common technique is to put a primary residence, vacation home, or other residential real estate asset into an LLC. Since most real estate ownership information is public record, an LLC owner provides a layer of anonymity, as the individual owner (of the LLC) is typically absent from the public record. This strategy has gained attention from families who wish to keep their real estate holdings private. Some states require an annual tax return and filing fee for LLC/LP entities and in some cases an additional fee based on annual gross receipts of LLCs (i.e., when the property is sold or rented). Check with your local jurisdiction regarding additional reporting requirements.

Insurance protection

A fundamental form of asset protection is insurance. Key types of insurance include: property and casualty, liability, medical, disability, long-term care, annuities, and life.

In shopping for new insurance or reviewing current coverage, it is wise to assess the financial strength of your insurance carrier, rather than take for granted any particular insurer's ability to pay claims.

Property and casualty insurance

Property insurance and casualty insurance are broad categories of coverage for loss and damage of property. Property insurance includes homeowners insurance, renters insurance, flood insurance, and earthquake insurance. Casualty insurance includes vehicle insurance (e.g., auto insurance, boat insurance, and airplane insurance), theft insurance, and liability insurance. Special rules apply to each type of coverage, and some states regulate auto insurance rates and coverage.

It's smart to find a respected agent to guide you through the process and help you price coverage options. Recent natural disasters underscore the importance of understanding what various insurance options do and do not cover.

It's also important to investigate whether one policy overrides or overlaps another, since you'll want to consider cancelling redundant coverage. Make sure that your policies cover all of your jewelry, artwork, and other collectibles and reassess your coverage every few years. A substantial home improvement project or the purchase of new electronics may no longer be covered by your existing policy. If you obtain combined coverage from one carrier, you may be eligible for a discount.

Liability insurance

Liability insurance protects an individual or business from the risk that they may be sued and held legally liable for an injury due to negligence or malpractice. 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 homeowners or auto insurance. Purchasing the maximum amount of coverage offered (premiums tend to be relatively low) may be prudent. Be sure to coordinate your umbrella policy with base levels of liability coverage under

your homeowners, 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 using the plane. While placing ownership of an aircraft in a limited liability company can offer certain advantages, it can also significantly alter or invalidate liability coverage.

Health insurance

There are generally three types of health care plans: plans provided through a health maintenance organization (HMO), those offered by a preferred provider organization (PPO), and point-of-service (POS) plans. An HMO requires that you use physicians within a specific network, offering less flexibility but lower costs. A PPO allows you to go out of the plan's network, but you will pay a higher fee than if you remain in the PPO's network. POS plans combine elements of an HMO and PPO. Under the Affordable Care Act, most Americans must either obtain health coverage, get an exemption, or pay a fee called the individual shared responsibility payment.

If you are 65 or older, eligible for Medicare, and have other health insurance or coverage, it is important that you understand how Medicare benefits coordinate with other benefits.

Increasingly, individuals are making greater out-of-pocket contributions toward their medical costs, including contributions to high-deductible plans that are designed to cover catastrophic medical events. High-deductible plans typically carry lower premium costs and tend to make consumers more cost-conscious when making medical decisions. When choosing coverage, you may want to consider setting up a health savings account to pay for prescriptions, contact lenses, and other frequent or recurring medical expenses.

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). As discussed in chapter 1, income tax does not apply to distributions from an HSA, as long as they're used for qualified medical expenses. For HSA distributions that are not used for qualified medical expenses, there is a 20% penalty added to the income tax.

Because an HSA can accrue savings tax-free, 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 tax-free earnings which can then be used later in life (after retirement). Health savings accounts are available to partners in partnerships and to shareholders in S corporations.

Disability insurance

Disability insurance replaces your earnings if you become 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, disability should be defined as not being able to perform your current job—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. For those costs, long-term-care insurance can be useful.

The decision to purchase long-term-care insurance is an intensely personal one, 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.

Annuities

Fluctuations in investment returns have caused many investors to consider annuities, which are contracts offered by insurance companies. Annuities have the advantage of tax deferral (earnings are not subject to income tax until paid out) but come with an additional layer of administrative costs. Annuities can be immediate or deferred and come in fixed or variable payouts.

An *immediate annuity* begins payments immediately after purchase and is often used as a source of retirement income. Recent low interest rates have made immediate annuities more popular for people who worry that they will run out of money in their retirement.

A *life annuity* provides payments for life and can have survivor benefits or refund features attached.

A *deferred annuity* is an investment account that builds value, tax-deferred, until payments are made at a later date (such as at retirement). This type of annuity is often used for wealth building.

A *fixed annuity's* investment return is based on the return produced by the insurance company's general assets. In an environment of low interest rates, the rate of return can be attractive, with many carriers paying rates of 3% or more. With fixed annuities, the investment risk is transferred from the policyholder to the insurance carrier.

A *variable annuity's* investment return is based on the investment choices made by the owner. These annuities provide a menu of investments that closely resemble those of traditional mutual funds. Some newer variable annuities provide a guaranteed minimum return in exchange for a larger administrative cost and may be attractive choices for those who do not want to invest in the stock market.

For income tax purposes, the earnings are not subject to tax until distributions from the annuity account occur. Generally, there is a 10% penalty applied if payments begin before the account holder is 59 ½ years old.

Common life insurance products

	Term	Whole	Universal	Variable
Temporary coverage	Yes	No	No	No
Premiums	Fixed level for term	Fixed level	Flexible or fixed level	Flexible or fixed level
Guaranteed death benefit	Yes	Yes	Yes	Yes
Builds cash value	No	Yes	Yes	Yes
Access to cash	n/a	Yes	Yes	Yes
Advantages	- Easy to understand - Least expensive	- Predictable - Tax-deferred cash accumulation - Lifetime coverage - Guaranteed cash value	- Tax-deferred cash accumulation - Flexible premiums and benefits	- Tax-deferred cash accumulation - Offers investment options - Greater growth potential
Disadvantages	- No lifetime coverage - No savings feature	- Lack of flexibility - Higher premiums	- Cash value depends on interest rate	- Investment risk/loss potential
Purpose	- Short to intermediate need	- Lifetime protection	- Lifetime protection (if cash value is sufficient)	- Lifetime protection (if cash value is sufficient)

Insurance carriers continually add, remove, and change policy features to meet the demands of a competitive market.

As with all investments, individuals should carefully evaluate investment costs and historic rates of return before investing. Remember that the financial health of the insurance carrier making the annuity payments is a critical factor to consider.

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. The amount of coverage, ownership of policy, and designated beneficiary are all factors to consider 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, remove, and change policy features to meet the demands of a competitive market. Further, it may be difficult to find a source of information about how life insurance policies compare with one another, the investment performance of each, or fee structures (such information is easier to find if you're researching mutual funds, for example). 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? Pay funeral expenses? Obtain protection in transitioning a business? Or, rather, is the insurance a form of investment?
- *How long will 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, do you intend 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 spouses? 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. Many insurance policies are owned by special vehicles such as a life insurance trust or a 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. There can also 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.

Common life insurance choices

The two main types of life insurance are:

- Term life insurance, which provides coverage for a specific time period
- Permanent life insurance, which provides coverage until you die (or cancel the policy)

Between these general types of insurance, there are various policy characteristics.

Level-premium term insurance—People seeking temporary life insurance most often find that their needs are met via level-premium term insurance. Under this type of policy, you pay the same amount for a set number of years, and then the coverage ends. This is very cost-competitive insurance, without additional features (adding features to life insurance makes comparisons difficult).

Whole life insurance—The need for longer-term life insurance can 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 insurance has both an insurance component and an investment component. The insurance component pays a stated amount upon death of the insured. The investment component accumulates a cash value that the policyholder can withdraw or borrow against. This type of coverage is predictable but not flexible.

Universal life insurance—Universal life insurance is another type of permanent life insurance but with fewer guaranteed features. It became popular in the 1980s and 1990s (a period of relatively high interest rates) as agents could engineer policy returns to illustrate lower premiums. Universal life insurance was created to provide more flexibility than whole life insurance by allowing the policyholder to adjust premium payments to suit changing investment conditions. However, many of the interest rate assumptions built into the illustrations could not be sustained and premium payments had to be increased to maintain the policy. The latest form of universal 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). Unfortunately, the pricing for this type of universal life insurance has changed recently due to low interest rates so that more traditional (and historically more expensive) types of policies have similar premiums.

Variable life insurance— Variable life insurance is another form of permanent life insurance that allows the policy owner to choose the investments, much like a 401(k) plan or IRA. Each carrier has a pre-selected list of investments within the policy and the policy owner is free to mix and match. Investments within the policy can be taken into account with other investments in an overall asset allocation (see chapter 2). These policies were popular in the late 1990s (due to robust stock market returns), then lost popularity when market returns turned negative. Interest in these policies has increased due to higher federal (and state) income tax rates, the Net Investment Income Tax (NIIT), and more attractive overall market returns. The investment growth within the policy is income-tax free. Policy cash values can be accessed during life through policy loans (as long as premiums are paid over multiple years) and the death benefit remains income-tax free. There can be significant tax benefits associated with investment-oriented life insurance, although the drag on returns associated with administration and mortality costs must be evaluated.

Life insurance is not for everyone, but you should not dismiss it without doing some research and evaluation of your situation

Private placement variable life insurance—Private placement life insurance is a special form of variable insurance. The term "private placement" means the policy owner can choose almost any type of investment within the policy (subject to insurance carrier approval). These policies are attractive for high-income taxpayers who wish to reduce income taxes with a long-term investment strategy. Again, the drag on returns associated with administration and mortality costs must be evaluated. The insurance carrier must be willing to include the investment in the policy; the chosen investment should produce reasonably predictable returns so that the complex tax requirements associated with qualification as life insurance can be met.

Second-to-die insurance—(also known as survivorship insurance or joint life insurance)—This type of insurance pays a benefit upon the death of the second of two jointly insured people. These policies are 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 strategies

Life insurance is not for everyone, but you should not dismiss it without doing some research and evaluation of your situation. Here are some examples of how life insurance can be used effectively:

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.

Traditional single-life products are appropriate 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 full-time employees through their jobs. Often, additional supplementary coverage can be obtained through employer-sponsored arrangements. However, because this coverage is available to all employees regardless of health issues, it can sometimes be more expensive than other 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 under distressed circumstances.

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

Due to a combination of current federal and (most) state estate tax laws, as well as features that are commonly employed in professionally prepared estate planning arrangements, the major estate tax typically is not due until the death of the surviving spouse. 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.

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.

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 corporate 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 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 if 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 it—and to rely

on life insurance to provide for the children who will not be running the family business. This can 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):* It is important to arrange life insurance in a tax-efficient manner when using it for business transitions. Changes in ownership can produce radically different tax results. This is especially true with buy-sell arrangements. 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. However, corporate redemptions are often tax inefficient. Instead, a cross-purchase agreement may be more beneficial from a tax perspective.

- *Funding cross-purchase agreements:* 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.

  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.

Life insurance as an investment

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

This type of insurance can also be an investment for the current generation. The reasons for this include tax-favored treatment for investment returns, high guaranteed returns, and non-correlated investment returns.

From an investment perspective, whole life and universal life contracts produce a return based on the insurance carrier's underlying portfolio. With today's low interest rates, many insurance carriers' professionally managed portfolios have produced attractive investment returns. Investment professionals find life insurance attractive because the investment returns do not seem to correlate with those of traditional asset classes; instead, they are 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 insurance 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.

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 found out the hard way.

Doug and Peter run a successful business with two other partners. After Doug's neighbor dies unexpectedly from a heart attack, it occurs to Doug 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.

Partners call a meeting

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.

3 years later…
Peter passes away

The insurance agent 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.

A dozen years later…
Doug quits the business

Doug's basis in the company is $2 million

When Peter passes away three years later, the company receives a $5 million death benefit. After an appraisal, Peter's stock is valued at $9 million, and the company buys the stock from Peter's widow.

The estate is audited. As a result of the audit, the value of the stock is increased by $1.25 million (Peter's share of the life insurance), and Peter's widow must pay $500,000 of additional estate tax.

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

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

Life insurance also has many attractive tax features. For instance, as discussed earlier with private placement variable life insurance, certain investments can be placed within a policy in an effort to defer or eliminate the annual income tax consequences associated with the investment. This strategy goes by many names, referred to variously as 7702 plans, private pensions, and private 7702 plans (7702 is the income tax code section that addresses life insurance qualification requirements). Some insurance professionals believe that a well-structured life insurance policy can produce better results than a traditional qualified retirement plan, such as a 401(k).

In these cases, the policy itself is being used as an investment "wrapper." The wrapper shelters the investments from current income tax. The economic decision 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. Current policy attributes suggest that it takes many years before the tax savings outpace the additional mortality and administration costs. For individuals with a long-term investment horizon, the life wrapper may become a popular investment alternative.

Foreign life products

Many foreign wealth-building strategies have life assurance policies or annuities as a core. Life assurance is simply a naming convention used in foreign countries for different types of investment accounts. It isn't really insurance for US tax purposes. Foreign life assurance and annuities often have special income tax or inheritance tax features in the country of origin. However, many foreign investment professionals are not aware that these strategies can often result in information reporting and income tax complications for US citizens and residents. Further, many arrangements are incorrectly translated into English as "life insurance," which further confuses the issue.

The US income tax treatment of these contracts is uncertain. The prevailing view is that annual increases in investment value should be subject to US income tax each year. The alternative view is that income tax is due only upon policy surrender or termination. There is a US excise tax imposed on policy premiums.

It is clear that these assurance or annuity products are subject to US information reporting—foreign financial reporting on FinCEN Form 114 (previously Form TD F 90-22.1), *Report of Foreign Bank and Financial Accounts* (FBAR) and Form 8938, *Statement of Specified Foreign Financial Assets*, which is attached to the individual's annual income tax filing (Form 1040).

These investments cannot be sold in the United States, due to insurance and securities regulations. They are usually sold to individuals working or living outside the United States.

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 as important as it is with 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 20 or 30 years from now. Several independent agencies such as Fitch Ratings

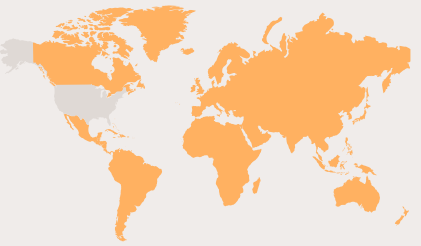
Foreign life products as an investment

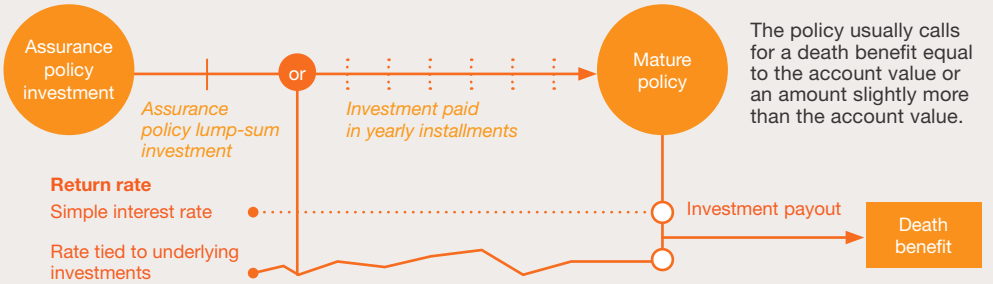
Compelling but not clear-cut

A popular investment outside the United States is something called a life assurance policy.* Upon purchasing such a policy, the buyer is promised a 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.





The policy usually calls for a death benefit equal to the account value or an amount slightly more than the account value.

What's clear

Life assurance policies are required to be reported annually on FinCEN Form 114, *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).

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 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.

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.

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.

and Moody's Investors Service rate insurance companies; those ratings can be helpful in selecting insurance carriers that are financially strong and stable.

Remember that many industries go through phases of consolidation, so your multiple life carrier portfolio may become a single carrier through acquisitions and mergers. Life policies and carriers must be monitored after purchase.

Working with your insurance advisor

Insurance planning is an important part of many 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 insurance advisors—one for property and casualty insurance (e.g., homeowners, 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 whether they are still appropriate for your needs and goals.

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
- Redundancies in your coverage are eliminated
- Premiums are sufficient to continue your life insurance coverage without the policy lapsing
- Financial risks are minimized

For example, does one disability policy cancel out or overlap another? Does it make sense to replace one policy with an 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 among the questions that you and your insurance advisor will want to address.

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 estimate 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, it should be approached with care. While many insurance and ownership options are available, 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 to your health and wealth.

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