Welcome to the 2020 edition of PwC’s guide to tax and wealth planning

The impact of the COVID-19 pandemic has resulted in significant financial reverberations within the United States and around the globe, affecting both businesses and individuals.

With a complete cessation of business activity across many industries and strict limitations on those enterprises allowed to stay open, there is an increased focus on liquidity and cash flow and an equally important emphasis on protecting employees and their jobs. In addition, many individuals have seen steep declines in the value of their investments, which may have income as well as estate and gift tax planning implications.

In response to the current economic impact, the US government enacted legislation that features significant tax provisions and other measures to assist businesses and individuals affected by the COVID-19 pandemic. Furthermore, the Federal Reserve made two emergency rate cuts, bringing the federal funds rate down to between 0% and 0.25%.

Working with financial, legal and tax professionals, businesses and high-net-worth individuals may want to reexamine their existing financial arrangements, determine how to take advantage of available relief provisions, and revisit priorities and strategies in an effort to weather the difficulties of the current economy. Being intentional in managing your business and your individual and family wealth can bring peace of mind and a greater likelihood of future financial success.

Thank you for registering with us. We plan to share updates on the rapidly changing economy and legislative environment as they happen throughout the year.

Frank Graziano
Personal Financial Services Leader, PwC US
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Effective tax planning can be challenging, given the complexity of the US tax code. Staying actively involved in your tax planning will help you ensure that the strategy your tax advisor pursues on your behalf will reflect and support your long-term wealth management goals. In this section, we discuss tax and wealth management issues that may apply to you.
On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), was signed into law and features significant tax provisions and other measures to assist individuals impacted by the economic effects of the COVID-19 pandemic. Additionally, the Federal Reserve made two emergency rate cuts, bringing the federal funds rate down to between 0% and 0.25%. Taken together with the rapidly changing economy, the following highlights some actions individuals may want to consider in the current tax year:

- Converting a traditional IRA to a Roth IRA – When a traditional IRA is converted to a Roth IRA, income tax becomes immediately payable on the value of the converted assets to the extent that there is not tax basis in the assets. Given the steep decline in the current market, converting to a Roth IRA now as opposed to having done so before the decline may result in less tax being due on the conversion, because the taxes would be based on the current fair market value of the assets held in the IRA. (For more detail, see page 11.)

- Deferring required minimum distributions (RMDs) – The CARES Act has waived the RMD rules for certain defined contribution plans and IRAs for the 2020 calendar year. This change allows taxpayers to avoid receiving a distribution, which may be a larger portion of the plan than they anticipated due to both the RMD being based on the prior-year ending value of the plan and the current depressed value of assets. (For more detail, see page 10.)

- Intra-family loans and mortgages – Loaning cash, as opposed to making an outright gift, can result in significant transfer tax savings. With the current low interest rate environment, the loan can be made for little cost. (For more detail, see page 12.)

- Intentionally defective grantor trust (IDGT) – An IDGT is an irrevocable trust funded by the settlor that is structured as a grantor trust for federal income tax purposes. The grantor can make a gift to the trust, but in the current economic environment, it may make more sense for the grantor to sell property to the trust in return for an
installment note bearing interest at the Applicable Federal Rate (note that the trust still may need at least a “seed” gift). Or, if an IDGT is already established and provides for the power to substitute assets, a grantor may consider swapping the trust’s assets with any depressed assets personally held. (For more detail, see page 39.)

- Grantor retained annuity trust (GRAT) – A GRAT generally is used as a vehicle to transfer the growth of assets in excess of the hurdle rate to the following generation. Due to the low interest rate environment, the April 2020 rate is at a historic low at 1.2%, and in turn, the annuity stream would be lower than what would normally be expected. Essentially, this planning technique transfers the asset growth in excess of the Section 7520 rate to the beneficiaries free of transfer taxes, so it may be advantageous to consider it with interest rates being low and assets being depressed. (For more detail, see page 37.)

- Charitable Lead Trust (CLAT) – A CLAT can be leveraged as a vehicle to make annual transfers to a charity or multiple charities for a period of time, while leaving the remaining assets of the trust to future generations with minimal transfer tax implications. In essence, the future generations would receive the appreciation of the trust’s assets in excess of the hurdle rate, so the technique may be advantageous to consider given the possibility of depressed assets and the current low interest rate environment. (For more detail, see page 41.)

- Sale of a private annuity – A private annuity sale is a transfer of property in exchange for the unsecured promise to make periodic payments to the transferor for their lifetime. The annuity is computed based on the fair market value of the property conveyed, the transferor’s life expectancy, and the applicable federal funds rate at the time of the sale. Given the current federal funds rate, the value of the annuity likely would be lower.

- Modification of limitations on charitable contribution deductions – The modified gross income limitation on the itemized deduction for charitable contributions is increased from 60% to 100% for cash contributions made during calendar-year 2020 to churches, universities, hospitals, or other public charities (see Section 170(b)(1)(A) for a list of qualifying organizations). Contributions to supporting organizations and donor advised funds (DAFs) are specifically excluded. (For more detail, see page 13.)

- Additional business related tax changes – In addition to the tax changes relating to individuals noted above, the CARES Act also included business related tax provisions. A few key changes include: certain net operating loss deductions can now be carried back five years, the excess business loss limitation rules will not apply for any tax years beginning after December 31, 2017 and before January 1, 2021, and a change in Section 163(j) interest deduction limitations, among other changes. (For more detail, see page 16.)
In addition to the economic and legislative impact of COVID-19 and the CARES Act, the 2017 Tax Cuts and Jobs Act (TCJA) made some notable changes for individual income taxes for the 2018—2025 tax years.

The highest marginal tax for individual taxpayers whose gross income includes interest, nonqualified dividends, short-term capital gains and passive income is 40.8%, reflecting the combined effect of the NIIT and regular income tax. For qualified dividends and most long term capital gains, the combined tax rate is 23.8%. Bearing these rates and additional taxes in mind will help you effectively engage with your tax advisor in creating a plan that results in the largest tax savings.

To this end, there are various tax planning techniques to consider based on income type. We are available to address tax deductions, as well as conduct a review of special considerations that may be useful for you to factor into your tax planning conversations this season. Given the volatility of the economy and markets, it’s best to discuss before executing any transactions, as these views are based on today’s current environment.
Earned income

Earned income typically comes from wages, self-employment income, bonuses and retirement plan distributions.

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.

**2019 Tax Brackets**

<table>
<thead>
<tr>
<th>Rate</th>
<th>Single</th>
<th>Married</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0—$9,700</td>
<td>$0—$19,400</td>
</tr>
<tr>
<td>12%</td>
<td>$9,701—$39,475</td>
<td>$19,401—$78,950</td>
</tr>
<tr>
<td>22%</td>
<td>$39,476—$84,200</td>
<td>$78,951—$168,400</td>
</tr>
<tr>
<td>24%</td>
<td>$84,201—$160,725</td>
<td>$168,401—$321,450</td>
</tr>
<tr>
<td>32%</td>
<td>$160,726—$204,100</td>
<td>$321,451—$408,200</td>
</tr>
<tr>
<td>35%</td>
<td>$204,101—$510,300</td>
<td>$408,201—$612,350</td>
</tr>
<tr>
<td>37%</td>
<td>$510,301+</td>
<td>$612,351+</td>
</tr>
</tbody>
</table>

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), which would result in the loss of some or all of the tax benefit that the deductions would have delivered.

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 so, 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 such strategy.

**Top tax rates for personal income**

<table>
<thead>
<tr>
<th></th>
<th>Wages</th>
<th>Long-term capital gains</th>
<th>Qualified dividends</th>
<th>Passive income</th>
<th>Active income from general partnership*</th>
<th>Active ordinary income from a LP or LLC*</th>
<th>Active income from an S corporation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicare tax on earned income</td>
<td>1.45%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>2.90%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Highest marginal income tax rate</td>
<td>37.0%</td>
<td>20%</td>
<td>20%</td>
<td>37.0%</td>
<td>37.0%</td>
<td>37.0%</td>
<td>37.0%</td>
</tr>
<tr>
<td>Net Investment Income Tax/ Medicare surtax</td>
<td>0.90%</td>
<td>3.80%</td>
<td>3.80%</td>
<td>3.80%</td>
<td>0.90%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Top total tax rate</td>
<td>39.35%</td>
<td>23.80%</td>
<td>23.80%</td>
<td>40.80%</td>
<td>40.80%</td>
<td>37.0%</td>
<td>37.0%</td>
</tr>
</tbody>
</table>

* 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.

Note: For 2018 - 2025, there is a new 20% deduction for qualified pass-through business income, which is not depicted in this chart. More detail on this complex provision is provided in the pages that follow.

**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 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.
Deferring taxable income via 401(k) plans

It is usually wise to make 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.

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, 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

With more flexibility in the timing of their compensation as well as when they pay their business expenses, business owners or self-employed individuals have an incentive to defer billing and collections until the following year. Conversely, individuals may be inclined to accelerate expense payments into the current year, since expenses will offset current year 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.

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. The bonus depreciation percentage increased to 100% for qualified property purchased after Sept. 27, 2017. This provision will phase down from 100% by 20% per year starting in 2023.
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 ($1,000,000 for 2019) 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 $56,000 for 2019 and $57,000 for 2020 or 20% of net self-employment income after deducting self-employment tax. Making such a contribution will offset the ordinary income earned, 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 individual tax return, including extensions (October 15, 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 solo 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—$56,000 for 2019. 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 considered.

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.

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.

Under the CARES Act, you may withdraw up to $100,000 from qualified retirement accounts in 2020, and the 10% early withdrawal penalty is waived. The withdrawal must be for a coronavirus-related distribution. In addition, the CARES Act waives the required minimum distribution rules for certain defined contribution plans and IRAs in 2020.
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,¹ but then the Roth IRA will grow tax-free, and there are no required minimum distributions during the owner’s lifetime.² Distributions taken from the account are also considered tax-free.

A Roth IRA conversion is something to consider, for example, in years where the assets in the Roth IRA may have a depressed value, or 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.³ 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.

It is worth noting that although the new tax law still allows Roth IRA conversions, it ends the ability to re-characterize a conversion (i.e., reverse it) after the fact. This is a provision that does not sunset. For more on tax considerations related to estate and gift planning, please see the Estate Planning section of PwC’s Guide to tax and wealth planning.

Investment income

Investment income includes 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%, including the NIIT. 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 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

¹ We strongly recommend that any taxes you end up owing as a result of the conversion be paid from funds outside the retirement account.
² The Roth benefits are available if the assets within the Roth account have been held in the Roth account for at least five years.
³ 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.
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 financial benefit for you 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. 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-term capital gains over short-term 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 40.8% (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, 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. 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.
Itemized deductions

The 2017 tax reform act made some important changes to deductions to take into consideration during tax planning. First, through 2025, personal exemptions were repealed entirely. Secondly, an individual is permitted to deduct up to $10,000 for any combination of state and local income taxes, property taxes, and sales taxes.

Charitable contribution planning should be done by year-end to ensure maximum deductibility and to determine if any charitable contributions should be deferred or accelerated. To be deductible in 2019, your cash charitable contributions to public charities should not exceed 60% of your AGI (100% of adjusted gross income in 2020). 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, particularly if the donation combines appreciated property and cash as the various adjusted gross income limits have interactions between them that can be complex. Lastly, it should be noted that for individuals claiming the standard deduction, an above-the-line deduction for charitable contributions of cash, up to $300, is permitted beginning in 2020. For more on tax considerations related to charitable contributions, please see the Charitable Giving section.
Harvesting unrealized capital losses
A potential way to offset capital gains

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

During the year, Bob also 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.

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.**

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* 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.
Other changes to itemized deductions

- Medical expenses: Out-of-pocket medical expenses in excess of 10% of adjusted gross income (AGI) are deductible.

- Mortgage interest: For any new acquisition indebtedness incurred after December 14, 2017, interest would only be deductible for loan amounts not exceeding $750,000 (for married filing jointly). The acquisition debt limit applies in aggregate on up to two personal residences. Existing mortgages as of December 14, 2017, continue to be subject to the current $1,000,000 limitation. Interest would no longer be deductible on a home equity loan unless the proceeds are used to substantially improve a home, and therefore meet the definition of acquisition debt.

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 to the extent that he or she has passive income in the current year or 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 with passive-activity loss carry forwards 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 redefine their status. You should consult your tax advisor regarding the passive-activity rules.
Net operating losses

If you are in an overall loss position for the year, you may be entitled to a deduction for a net operating loss (NOL). Significant planning opportunities become available with net operating losses because you have the option to offset the losses with future income.

Effective for losses arising in tax years beginning in 2018, the taxpayer is limited to a net operating loss deduction of 80% of taxable income (determined without regard to the deduction). The CARES Act permits a five-year carryback of NOLs arising in a tax year beginning after 2017 and before 2021. The NOL deduction generated by the carryback is not limited to 80% of taxable income, but instead can fully offset taxable income. Any NOL arising after this period is permitted to be carried forward indefinitely. This provision does not sunset.

Business losses

Business losses in excess of business income plus $500,000 (married filing a joint return) are not deductible starting in 2021 under the CARES Act. Such losses are treated as a net operating loss (NOL) carryforward to subsequent taxable years. This limitation would apply after the application of the passive-activity loss rules. Business losses covered by this provision would include pass-through losses as well as sole proprietor and farm losses. In the case of partnership and S corporation losses, the limitation is applied at the partner or shareholder level.

This provision limits the ability of taxpayers to use large business losses to offset other income in their returns (e.g., wages, interest, dividends, capital gains). It appears that the limitations applicable to NOLs would apply to the carryover loss in subsequent years, but additional guidance may be needed for this provision.

The original provision enacted under the TCJA put the limitation into place starting in 2018, which was then pushed to 2021 in the CARES Act. This change is retrospective, so any excess business loss limitation claimed in 2018 would need to be amended, as you are not able to claim the NOL created from such in 2019. Additional guidance may be needed for this provision.

Business deductions for owners and their companies

Strategic tax planning for business owners and their companies should consider all the strategies discussed in this section, 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.
New deduction for qualified pass-through business income

The new tax law provides a 20% deduction for qualified business income from a partnership, S corporation, or sole proprietorship. The 20% deduction combined with a top ordinary income tax rate of 37% results in a top rate of 29.6% for such income in the absence of other limitations.

In general, qualified business income is the net amount of qualified items of income, gain, loss, and deduction for any qualified trade or business. Qualified items include income, gain, loss, and deduction connected with a qualified trade or business in the US. Qualified business income does not include investment-type income (e.g., capital gains, dividends, and non-business interest) or reasonable compensation and guaranteed payments. A qualified trade or business is any business other than a ‘specified service trade or business’ (SSTB) or service performed as an employee.

For an individual whose taxable income exceeds the relevant income thresholds, the deduction of each qualified business’s income is capped at the greater of (a) 50% of the individual’s allocable share of W-2 wages, or (b) the sum of 25% of the individual's allocable share of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property (the ‘W-2 wage limitation’). The W-2 wage limitation does not apply to qualified REIT dividends, cooperative dividends, and publicly traded partnership income, regardless of the individual recipient’s taxable income.

Neither the W-2 wage nor the SSTB limitation applies to an individual whose taxable income is less than $160,700 for a single filer ($321,400 for a joint filer) for 2019. Above these thresholds, the W-2 wage limitation phases in over the next $50,000 of income ($100,000 for joint filers). The law defines ‘specified service trade or business’ as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. In addition, a specified trade or service business includes investing and investment management, trading, and dealing in securities, commodities, or partnership interests.

This new provision is complex. Consultation with your tax advisor is recommended.

Aircraft ownership

The use of personal aircraft creates additional opportunities for strategic tax planning for individuals as well as businesses. While the tax code allows certain business deductions for aircraft, the rules are complex. With regard to aircraft ownership and issues such as depreciation, lease payments or financing, you should consult with your tax advisor.
## Aircraft: Ownership options

<table>
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<tr>
<th>Full ownership</th>
<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td></td>
<td>• Most flexible option</td>
<td>• Complicated and time-consuming</td>
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<tr>
<td></td>
<td>• Revenue opportunities through charter</td>
<td>• Residual value and liability risks borne with owner</td>
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<tr>
<td></td>
<td>• Tax benefits—depreciable asset</td>
<td>• Generally highest total cost alternative, though economies of scale minimize this cost disadvantage as utilization increases</td>
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<tr>
<td></td>
<td>• Complete control over plane and crew/consistency</td>
<td>• Long-term commitment</td>
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<tr>
<td></td>
<td>• Aircraft</td>
<td>– Capital</td>
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<td></td>
<td>• Service</td>
<td>– Staff</td>
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<td></td>
<td>– Cost</td>
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<td><strong>External management advantages</strong></td>
<td><strong>External management disadvantages</strong></td>
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<tr>
<td></td>
<td>• Volume pricing on some fixed and variable costs such as fuel, insurance, training, maintenance, and hangar space</td>
<td>• Higher management cost</td>
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<tr>
<td></td>
<td>• Less required oversight</td>
<td>• Potential day-to-day variation in crew</td>
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<td></td>
<td>• Employees not on payroll</td>
<td>• Not likely to get same level of service as with dedicated internal development</td>
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<tr>
<td></td>
<td>• Ability to generate revenue through external charter</td>
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<tr>
<th>Fractional ownership</th>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td></td>
<td>• Professionally managed and maintained</td>
<td>• Generally higher cost than charter</td>
</tr>
<tr>
<td></td>
<td>• Guaranteed availability of your plane or a comparable one</td>
<td>• Capital commitment required</td>
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<tr>
<td></td>
<td>• Depreciable asset</td>
<td>• Limit on number of flying hours during peak holiday periods</td>
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<td></td>
<td>• Operating efficiency</td>
<td>• Penalty if utilization does not match share size</td>
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<td></td>
<td>• Lower upfront capital outlay</td>
<td>• Total expenses do not scale with utilization</td>
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<td></td>
<td>• Highest level of outsourced consistency</td>
<td>• Aircraft upgrades can be costly</td>
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<tr>
<td></td>
<td>– Crew training</td>
<td>• Residual value risk</td>
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<td></td>
<td>– Maintenance</td>
<td>– Generally lower-than-average residual value based on high aircraft utilization</td>
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<tr>
<th>Flight cards</th>
<th>Advantages</th>
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<tbody>
<tr>
<td></td>
<td>• Guaranteed availability</td>
<td>• Generally higher overall cost than fractional</td>
</tr>
<tr>
<td></td>
<td>• No long-term commitment</td>
<td>• Total expenses do not scale with utilization</td>
</tr>
<tr>
<td></td>
<td>• Professionally managed and maintained</td>
<td>• Aircraft upgrades can be costly</td>
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<tr>
<td></td>
<td>• Operating efficiency</td>
<td>• No tax depreciation benefit</td>
</tr>
<tr>
<td></td>
<td>• Access to fractional fleet</td>
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<tr>
<td></td>
<td>• Highest level of outsourced consistency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– Crew training</td>
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<td></td>
<td>– Maintenance</td>
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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 stand-alone taxes for higher-income taxpayers.

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) on various types of investment income (uneearned 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 your approach with your tax preparer.

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. 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. Any such regrouping should be discussed with your tax advisor in detail before making this election.
Net Investment Income Tax (NIIT)
How does it work?

Here are three scenarios:

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 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 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 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.

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. 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.
Alternative minimum tax

The alternative minimum tax (AMT) causes confusion and concern for many. 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.’

A modified AMT was retained with tax reform, with increased exemption amounts and phase-out thresholds. For 2019, the AMT exemption amount is $111,700 for joint filers and $71,700 for all other taxpayers other than estates and trusts. The phase-out thresholds increase to $1,020,600 for joint filers and $510,300 for all other taxpayers other than estates and trusts.

The AMT had a significant effect for taxpayers living in states with high income taxes because the deduction for state and local income taxes was not allowed in the AMT computation. With the increased exemption, the $10,000 limitation on the state and local tax deduction, and the repeal of miscellaneous itemized deductions, fewer taxpayers will be impacted by the AMT.

It is important to be actively engaged in your tax planning to understand how the AMT might affect your tax liability. The AMT needs to be considered when 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 equals your AMT liability. 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. However, children under age 18 and full-time students under age 24 will be taxed at trust rates, rather than cross referencing to the parent’s tax return on investment income that exceeds a threshold amount of $2,200 in 2019, potentially preventing any tax savings from the shifting of such income to children.
Note that 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.

Further, 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 gains that 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. Some overlook the personal tax effects and filing requirements of hiring such household employees. 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 2019, it’s $2,100), 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.

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 makes sense for you. Please find more information on insurance in the Risk management section of PwC’s Guide to tax and wealth planning.
Worldwide income considerations

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.

There are two common forms that, if applicable, must be filed to disclose certain foreign asset holdings:

- FinCen Form 114, Report of Foreign Bank and Financial Accounts (FBAR), 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.
- Form 8938, Statement of Specified Foreign Financial Assets. This requirement is one of the Foreign Account Tax Compliance Act (FATCA) provisions and stipulates that taxpayers must file with their individual tax returns if they hold certain foreign financial assets that exceed specific thresholds. 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 complex and varied regulations involved in cross-border living, working and investing make it vitally important for families and their advisors to be up to speed on all of the reporting rules for their tax planning. Families with more than one citizenship, residences around the world, children studying abroad or regular international business travel may face unexpected tax consequences if they are unfamiliar with the various requirements. For more on tax considerations related to non-US financial events, please see the Crossing US borders tax considerations section of PwC’s Guide to tax and wealth planning.
For high-net-worth individuals, comprehensive tax planning requires careful attention across a wide range of areas and geographies, some of which we’ve discussed in this section. 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 also that of the next generation.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
There are many potential objectives to weigh, both financial and nonfinancial, in estate planning. This report is intended to help you make sound assessments for you and your family. We discuss the attractions and potential disadvantages with popular options for transferring wealth, such as revocable and irrevocable trusts, life insurance trusts, and charitable gifts.

We also cover tax implications involved in estate and gift planning, which are crucial in the development of your plan. Periodic review will be required as it is likely that estate and gift tax rules will continue to change in the coming years. For example, US tax reform doubled the exemption for federal estate, gift and generation-skipping taxes (GST).¹

¹ Many states have some form of death tax. You and your advisors should check to see whether there are differences between the federal estate and gift tax laws and the laws in your local jurisdiction.
Although each person’s situation is different, we find this four-step process to be the most effective path:

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<td>Assess your current state and future goals</td>
<td>Choose the options that fit your needs</td>
<td>Implement your estate plan</td>
<td>Review your plan regularly</td>
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Step 1: Assess your current state and future goals

The creation of a personal balance sheet is an effective starting point in taking stock of your financial situation. 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.)
- Evaluating the appreciation potential for various assets

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

- 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 according to your wishes—e.g., specifying who receives your property, the amount the recipient receives, the form in which he or she receives it (outright or held in trust), and who will manage your property for your heirs
- Making sure your property is transferred in an efficient, quick and orderly manner
- Reducing the overall estate and gift tax liabilities—e.g., reducing the assets that are subject to tax, deferring the payment of tax and taking maximum advantage of available exclusions, exemptions, deductions and credits

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.
• 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. 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: Choose the options that fit your needs**

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

**Draw up a will or consider a revocable living trust**

If you do not have a will, the law of your state of residence will generally determine who receives your property when you die, 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 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 account for these rules within the estate plan.

You may also consider a revocable living trust, which is also known as a will substitute. A revocable living trust has three main advantages: (1) it avoids probate, (2) it provides confidentiality, and (3) it protects in case of incapacity. If you live in a state with a complicated or onerous probate process, creating a revocable living trust and transferring all assets owned in your individual name (other than retirement plans or life insurance) may make sense to avoid the probate process at your death. A will is also a public document upon your death, so putting your assets in a trust provides privacy. Finally, if you become disabled, a successor trustee can step in immediately to manage assets, unlike an agent listed on a power of attorney (discussed below) who usually needs authorization by the bank or other financial providers.
Be prepared in case of incapacity

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

Designate an executor and trustee

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

Review property ownership and beneficiary designations

For couples, part of the estate planning process involves evaluating whether you and your spouse (or partner) each have enough property in your separate names to take full advantage of the estate, gift, and generation skipping transfer (GST) tax exclusions, exemptions, and credits that are in effect. A review of asset ownership can help you determine whether lifetime gifts or transfers between you and your spouse or partner should occur to make sure that you each have enough assets in your own names to take full advantage of these benefits. The federal portability law may allow you to take full advantage of both spouses’ exemptions. However, there are requirements that must be met. 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 can significantly increase your overall tax liability.

Bear in mind 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.
On the other hand, owning property and assets in this manner may provide creditor protection benefits, so this factor needs to be evaluated at the same time as the estate tax implications.

Another consideration to keep in mind is that if you live (or used to live) in a community property state, and are married, most assets and property acquired while you were living in that state as a married person are generally treated as half-owned by each spouse, regardless of who the named titleholder is. This can cause issues if you try to pass the entire asset to someone other than your spouse without your spouse’s consent.

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 periodically review the beneficiary and 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**

To the extent you did not implement a comprehensive estate plan (or to the extent circumstances have changed since the plan was put into place), disclaimer planning can be used as post-mortem 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 a taxable situation because he or she may already have a taxable estate, or the beneficiary may not want to add to an already large estate.

Another reason to use a disclaimer is to allow a surviving spouse to determine which assets are retained by the spouse and which 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. 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.

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3. Nine states operate under some form of 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.
There are specific requirements for making a qualified disclaimer. The disclaimer must be made within nine months of the date of the transfer (i.e., date of death for inherited property) and the disclaimant cannot have accepted any benefits of the disclaimed property before disclaiming. Individuals considering a disclaimer should speak with their advisors to make sure the disclaimer is timely and fulfills all requirements of state property law, as well as the federal and state tax law requirements.

Planning for unusual and unique assets

Ownership of unusual and unique assets (e.g., artwork, wine collections, book collections, jewelry, sports memorabilia) 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.

These assets often have sentimental value, so it is important to determine who will want them, 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 exemption. Further, these assets are generally valued at fair market value at the date of death, so it may be beneficial to acquire an appraisal of these assets during life in an effort to have your property distributed by value according to your wishes.

Consider the form and amount of property left to your spouse

Providing for the surviving spouse is often the primary estate planning goal. For both estate and gift tax purposes, there is an unlimited marital deduction for amounts transferred to a spouse if he or she 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 in one or more of three ways: (1) outright, (2) via a “general power of appointment” trust, or (3) via a “qualified terminable interest property” (QTIP) trust.

Assessing how these options will best help you meet your goals is important. 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. Understand that with this type of transfer, 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 wise 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 qualifying 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 spouse to die first does not have control over the ultimate disposition of the property with this type of transfer. It is important to consult the estate tax rules in the state where you reside. In some states, the “general power of appointment” trust is the only type 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 QTIP 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 spouse who dies first decide who will receive the remaining property upon the death of the surviving spouse.

This arrangement may alleviate concern about both financial management and 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 period of 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 and followed each year in order to maintain the marital deduction. For more information on QDOTs, please refer to the “Crossing US borders: Tax Considerations” section of this Guide.

**Take advantage of the estate tax exemption**

The basic exemption amount for federal estate and gift taxes, and the exemption amount for GST taxes, doubled with tax reform to $10 million (before inflation adjustments) through 2025 ($20 million for married couples). These increases are scheduled to sunset and revert to 2017 law in 2026. For 2019, the inflation-adjusted amount is $11.4 million ($22.8 million for married couples). The gift tax annual exclusion is still $15,000. For 2020, the exemption increases to $11.58 million ($23.16 million for married couples), and the annual exclusion remains at $15,000.

The gift and estate tax exemptions will remain unified so any use of the gift tax exemption will decrease the estate tax exemption available at death. Further, the law allowing a ‘step-up’ in basis to fair market value at date of death will continue. The top estate and gift tax rate is still 40%.
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.*

* The top estate and gift rate is 40%. This assumes that Tom had already exhausted his $11.18 million exemption during his lifetime.

For more information on QDOTs, please refer to the ‘Crossing US borders’ section of this guide.

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.
Carefully evaluate the benefits of portability

Portability allows the transfer of any unused lifetime estate and gift tax exemptions of a deceased spouse to the surviving spouse. Thus, a married couple is entitled to a joint exemption equal to two separate individual exemptions no matter how much of the estate is owned by either spouse.

However, the portability is not automatic. The executor of the deceased spouse must file an estate tax return in order for the transfer of the unused exemptions to take place.

Some states that impose a separate state estate tax recognize portability, but many 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 alone could mean the loss of a significant opportunity. Keep in mind that portability does not apply to the GST tax exemption.

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 $15,000 for 2019 ($30,000 if you’re married and your spouse consents to gift-splitting) to any number of people annually without having to pay 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 use several alternative account and trust arrangements that will qualify your gift for the annual exclusion without requiring outright transfers.

In addition to the 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, an individual could transfer up to $75,000 to a 529 plan in 2019 and elect to treat the contribution as having been made over five years.
Consider trusts and family entities as part of your wealth transfer strategy

Trusts can also be valuable tools in transferring wealth. There are a number of types to consider.

Why you need an estate plan

Though estate planning can be complex, it delivers clear rewards by creating peace of mind for you now and security for your family down the line. You should have some form of estate plan—or review existing plans—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 own a business.
- You have a blended family.
- 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:

- 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 to appoint guardians for your children
- Court appointment of a representative to make financial or healthcare decisions for you if you are incapacitated
- 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
Life insurance trust

When your life insurance policy pays out to your beneficiaries, those proceeds are included in your gross estate and are subject to estate tax. If that policy is transferred into an irrevocable trust to manage and distribute the death benefit, the proceeds are protected from estate tax. 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 may want to 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.

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 the fair market value of the property at the time you create the trust plus 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 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 to 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.

Because interest rates are currently low and various limits have been proposed over the years for GRATs, it may be wise to consider a GRAT sooner rather than later.
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 one million shares of Robinson, Inc. stock, valued at $1 per share (total value $1 million).*

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.

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.**

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%.  

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PwC’s Guide to tax and wealth planning
**Intentionally defective irrevocable trust**

Use of 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 a 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 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 (although the IDIT should be properly “seeded” before the sale, which means that it should have some amount of equity that would substantiate the trust’s ability to make payments on the loan). 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 depend on the length of the note and the frequency with which interest payments must be made (e.g., annually, semiannually, quarterly). Similar to GRATs, 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 GST 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.

Although the IDIT will be the legal owner of the asset, you will remain liable for the 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 IDITs, so if you’re considering setting one up, it may be a good idea to do so sooner rather than later.
Dynasty trust

A dynasty trust is generally created as part of a plan to mitigate the impact of the 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—such as grandchildren.

The GST tax is in addition to potential estate or gift taxes on the same transfer. It is designed to make sure that a tax is, in fact, collected on the transfer of wealth from one generation to the next. A dynasty trust helps you take full advantage of your GST tax exemption and is typically set up to last for as long as the state law governing the trust allows.

A dynasty trust may be established either during your life or through your will. It 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. These techniques are not always mutually exclusive so an IDIT could also be structured as a dynasty trust.

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.

Her accountant and estate attorney 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.

* In 2019, the lifetime gift tax exemption is $11.4 million.

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.
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. The payment of rent is an excellent means to further reduce the estate. The grantor would need to survive the term in order for assets to be excluded from his/her estate.

A QPRT is especially desirable when significant appreciation is expected in the home’s value, since any appreciation that occurs after the trust is created can escape estate and gift tax. In addition, 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.

Charitable trust

Trusts can help you to achieve your charitable objectives and obtain a charitable deduction while still retaining an interest in your property or 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 information, please refer to the “Charitable giving” section of this Guide.
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 ($15,000 in 2019) to help her avoid using her lifetime gift tax exemption.
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, both of which are 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 or grandchildren, or setting up 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, such partnerships offer protection of assets from creditors. Finally, they 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 whether the value of a partnership unit should be discounted for gift or estate tax purposes. If the IRS invalidates the partnership, the discount related to the partnership is removed, and occasionally the entire gift is invalidated.

The IRS continues to challenge family partnerships that do not have good facts (e.g., no business purpose, deathbed planning, too much control over distributions). 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. However, if properly structured and operated, an FLP can be a very useful tool.
Cross-border considerations

Transfer tax treaties

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

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

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

Foreign-based property

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

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

You might also want to consider whether to use (1) a single will to dispose of all property worldwide or (2) separate wills governing the transfer of property in each jurisdiction where major assets are located, along with a will for the disposition of your remaining assets. 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.
Step 3: Implement your estate plan

A qualified attorney who has estate and gift planning experience relevant to your needs is crucial to the success of your estate plan. The estate and trust attorney should prepare documents for your review to ensure accuracy. You may also want a tax advisor involved to make sure your estate plan is aligned with any tax planning you already have in place and to serve as a second pair of eyes for the documents. Most importantly, the attorney and any advisors must make sure that the documents are properly executed in accordance with state law.

Implementation also involves producing an estate tax balance sheet that reflects the flowchart prepared during the planning process to illustrate how the estate will pass according to the new plan. The flowchart would, as described earlier, include the estimated estate tax due under the new plan and a liquidity analysis to determine how the tax and other expenses will be paid.

Step 4: Review your plan regularly

The final step in the estate planning process is to review and monitor your plan regularly. Over time, you may find it necessary to adjust your plan to reflect changes in:

- Your objectives or their relative importance to you
- The composition of your family (e.g., 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 re-evaluate your estate plan in light of any tax law changes. By working with your advisors, you can see to it that your income tax planning is aligned with your estate planning.
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 to ensure that your wealth and your vision for it will survive well into the future.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
Without private philanthropy, few charitable organizations and the public good that they do would survive. Planned properly, charitable giving can also be an effective tool in your overall wealth management strategy. It does this primarily by offering a tax-efficient means to transfer wealth. You may, for instance, find that making a philanthropic donation is an attractive alternative in 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 as a secondary consideration. There are a variety of ways to achieve these objectives.
There are a number of commonly used charitable structures. Each carries different tax and non-tax implications. Your investment and tax advisors should be able to help you find a way to achieve your goals within the most appropriate structure. No charitable strategy should be undertaken without an understanding of its impact on your current and long-term wealth management plans. Once you transfer assets to a charitable organization, they are no longer within your control.
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.

Gifts of cash to public charities are fully deductible up to 60% of a donor’s adjusted gross income (AGI). Gifts of appreciated securities are usually deductible up to 30% of a donor’s AGI. A gift that combines cash and appreciated securities can be considered as part of a strategy to maximize deductions. However, it’s wise to speak with your tax advisor before making such a donation as the limit is not clear cut. To the extent that 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 may 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 used, since such funds enable donors to request that their charitable donations be used in specified ways. Because tax reform resulted in some individual contributors choosing to bundle their donations into one year in order to itemize deductions, interest in DAFs increased. The popularity of these funds also has increased with corporations.

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1 Throughout this section, 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.
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, with a marginal tax rate of 37%.

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 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 that is equal to the fair market value of the assets donated ($50,000), thus reducing her income tax burden by $18,500 for federal tax only as states vary on the ability to deduct charitable contributions.

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

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 a 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 claim 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.
Donor-advised funds can provide many of the same benefits as private foundations, but without the administrative requirements and formalities associated with private foundations. For example, DAFs provide a current-year charitable deduction with the ability to release the funds to charities in future years, and a degree of intergenerational control. They also provide 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 which 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.)

You may want to weigh the comparative advantages and disadvantages of donor-advised funds against those of private foundations.
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 to 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. In the latter case, the deduction will be equal to 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 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—60% 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 multi-generational 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.

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.

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
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, 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 upon 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 alternatives. 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
Deferred gifts

Many donors choose to make charitable gifts that do not take effect right away. 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 include 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 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 charitable deduction for income tax purposes 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 for 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 equals the difference between the fair market value before and after the easement was granted, absent comparable sales of easements.

Charitable remainder trust

The charitable remainder trust (CRT) offers various structures of deferred giving. The trust is created to pay income to individuals then, once 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. 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 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. 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 beneficiaries die, the trust 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. If the donor prefers the income to be consistent, an annuity trust will pay out a set amount each year. In comparison, a unitrust fluctuates based on investment performance and the annual value of the trust.

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) allows 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: the income beneficiary may no longer need the annual payout and wants to give 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. If the income interest is donated, the income beneficiary would likely be able to claim a charitable deduction for the 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 of time, 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 a charitable deduction for income tax purposes 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 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 a charitable deduction generally equal to the value of the annuity paid to charity to use against the CLT’s own income. A nongrantor CLT also could use the annual payments it makes to charity to reduce the Net Investment Income Tax (NIIT).

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.
Charitable lead trust
Helping charities now, while investing in future generations

Mark and Amy transferred appreciated securities with a value of $1 million 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.

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 million 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.

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

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.
International charitable giving

Today, charitable giving by US individuals has an increasingly global reach. Because US income tax rules governing international charitable donations can be complex, it’s important to consult a tax advisor.

Generally, an individual’s contributions to a non-US charity are not deductible because US tax rules specify that qualifying charities 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 those countries.

US individuals wishing to make donations to charitable organizations in countries that aren’t specified in these treaties 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. 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 ensure that the foreign entity receiving the donations is considered equivalent to a US charity and oversee the foreign charity’s usage of the funds.

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 strategy tailored to your goals.
Deciding if charitable gifts fit your wealth management plan

Using the charitable strategies discussed in this section can add a layer of complexity to your wealth management plan and involve relinquishing control over some of your assets. 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 the type and value of the cash or property contributed.

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<thead>
<tr>
<th>Cash contributions of any amount</th>
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<tbody>
<tr>
<td>A bank record of the donation or a written receipt or communication from a charity (including name, date and amount) is required before a donor may receive a deduction for a cash contribution.</td>
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<tr>
<th>Cash and property contributions of $250 or more</th>
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<tbody>
<tr>
<td>A donor must obtain written acknowledgment from the charity for a contribution (in cash or other property) of $250 or more. A cancelled check or other record (in lieu of a formal written acknowledgment from the charity) is not sufficient. The acknowledgment must be obtained no later than the due date (or extended due date) of the tax return for the year of the contribution.</td>
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The written acknowledgment must explicitly state whether the recipient provided any goods or services in consideration for the contribution. If so (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).

<table>
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<tr>
<th>Property contributions of more than $500</th>
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<tr>
<td>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.</td>
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<tr>
<th>Property contributions of more than $5,000</th>
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<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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 section 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, there are complexities in implementing a postmortem charitable strategy and proper steps should be taken to ensure that the estate tax charitable deduction isn’t lost.

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. Only some gifts qualify, and the tax benefit is not automatic. 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. 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). Note that payments made in exchange for tickets or seating rights at college athletic events are no longer be deductible. (For 2017 and previous years, 80% of the payment could be treated as a charitable contribution.)

Taxpayers should also be careful to obtain and retain 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.

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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.
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 have found the latter to be among the most rewarding aspects of managing family wealth.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
As more people spend time outside their home countries and diversify with global investment portfolios, more are encountering the complex and varied regulations involved in international taxation. It’s important for families and their advisors to be informed and current on all of the tax and reporting rules. Those with more than one citizenship or with residences around the world; families that have children studying abroad or people who regularly conduct international business travel may face unexpected tax consequences if they are unfamiliar with the various requirements.
The United States is unusual in that it taxes its citizens on income regardless of where that income is derived or where citizens reside. Therefore, a US citizen living and/or working abroad may have his or her income subject to tax both in the US and the foreign jurisdiction.

The US also taxes non-US citizens (“foreign nationals”) who are considered US income tax residents on worldwide income. These include permanent residents who hold green cards as well as other foreign nationals who spend more than a specified number of days in the United States over three consecutive calendar years (with certain exceptions) or who make certain residency elections.

Foreign nationals may sometimes be considered nonresident aliens for federal income tax purposes if they are also considered tax resident in countries with which the United States has an income tax treaty in effect and certain requirements are met. An individual visiting the US temporarily (e.g., for a short-term work assignment) may inadvertently become a US income tax resident under the “substantial presence” test by extending the stay for other reasons (e.g., with a vacation in Florida). If the foreign national exceeds the number of days that he or she can remain in the US to retain nonresident alien status, that person would generally not only have to pay taxes on worldwide income, but may also have to fulfill significant reporting and disclosure responsibilities for non-US investments under US rules.

For individuals contemplating moving to or spending significant time in the United States, or obtaining green cards, it is vital to seek advice in order to avoid unwelcome tax consequences.

1 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 types of taxes.
Nonresident Aliens

Noncitizens who are not considered tax residents of the United States (nonresident aliens) are subject to US income tax only for income that is derived from a source in the United States or that is effectively connected with a US trade or business. Nonresident alien taxpayers who have US-sourced and/or income effectively connected with the US 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 exclude certain types of income from US taxation, that avoid double taxation, or that subject the income to lower tax rates.

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

Accidental resident

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

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

When Amanda’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, Amanda inadvertently becomes a US resident.

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

Amanda 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 Amanda might lessen the tax effect of her new residency status.
Avoiding taxation from multiple jurisdictions

The US tax system provides various forms of relief for US citizens and US tax residents who receive income from foreign sources to avoid taxation by multiple jurisdictions. The most common form of relief is the foreign tax credit, which provides a credit against US income tax for taxes paid to foreign jurisdictions on income sourced outside the United States in certain cases, subject to limitations and special rules.

Under the foreign earned income exclusion—another form of relief—US taxpayers employed and residing outside the United States can exclude from taxation up to $105,900 for 2019 of foreign earned income and $107,600 for 2020, as well as exclude (or sometimes deduct) certain housing expenses, as long as specific criteria are met. Foreign taxes allocable to excluded foreign earned income are not eligible for credit and must be ‘scaled down’, while special rules apply to determine tax rates applicable to non-excluded income. Note that these exclusions are not dependent on double taxation, however, and thus may be utilized by US persons residing in locations that do not impose an income tax.

US persons living and working in high-tax jurisdictions, such as Japan and most European countries, should consider whether claiming foreign tax credits alone on foreign earned income is more beneficial than pairing the foreign earned income and housing exclusions with foreign tax credits. Qualified tax advisors can run projections to determine the most tax-efficient approach.

The timing of foreign tax payments and recognition of foreign source income for the purpose of claiming foreign tax credits is another key consideration for US persons (and nonresident aliens in very limited circumstances). Failure to plan the timing of foreign tax payments and/or recognition of income properly can result in a mismatch between the tax years when the income was earned versus when the tax is considered creditable. This could result in the income being subject to US taxation in one year, but the taxpayer receiving the credit for the foreign taxes in a different tax year when the taxpayer might not have foreign source income, meaning that he or she may not be able to use the foreign tax credit to avoid double taxation.

Foreign jurisdictions may operate 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 and provide flexibility in two key ways. Individuals may elect to claim foreign taxes as creditable in the year the taxes accrue versus the year they are paid. The election applies to future years. Unused foreign taxes can be carried back one year and forward up to ten years to be utilized against foreign source income received in such years. In rare circumstances, it may be beneficial to treat foreign taxes as current year itemized deductions. Note that the new $10,000 cap on itemized deductions for state/local income and property taxes (as a result of 2017 tax reform) does not apply to the foreign income tax deduction.

2 Under US tax rules, a ‘US person’ has specific meaning and includes people who are US citizens, green card holders or resident aliens. The IRS details its taxpayer classification system here.
Foreign investments

Investing directly in foreign assets (or indirectly through fiscally-transparent entities, such as a partnership or a trust) often requires additional reporting and compliance for US taxpayers. 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. It is important to structure investments in foreign assets appropriately to retain the benefits of the investment while avoiding potential penalties and unnecessary compliance burdens.

Foreign corporations

Placing assets in a foreign corporation may defer income until the corporation declares a dividend or until the stock is sold. Since the corporation is foreign, the income earned may not be subject to US income tax (typically 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, applicable to controlled foreign corporations (CFCs) 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 CFCs and passive foreign investment companies (PFICs). In general, a foreign corporation that is owned more than 50% by a limited number of US shareholders is classified as a CFC.\(^3\) 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. Certain investments, such as foreign mutual funds, may be treated as PFICs. Furthermore, ownership of a CFC or PFIC can require considerable 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. Tax reform passed in 2017 introduced additional special rules related to CFCs whereby attribution can occur due to ownership in US corporations, as well as provisions resulting in taxation of previously deferred foreign earnings. The CFC and PFIC rules are complex, so it is important to get appropriate counsel when navigating them.

As with all informational forms required by the US tax authorities, failure to complete and submit tax forms with respect to foreign corporations on time can result in steep penalties, forfeiture of preferential tax treatment on certain income, 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 demands required under the US tax code.

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\(^3\) 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. As a result of 2017 tax reform, attribution rules may apply whereby stock of a foreign person is be treated as owned by a U.S. person, i.e., “downward attribution” of stock ownership from a foreign person to a related U.S. person.
Foreign currency exchange gain or loss

Some taxpayers also invest directly in foreign currency as a strategy. In recent years, the currency markets have seen extensive volatility, creating investment opportunities but also exposing US taxpayers to significant risks.

For purposes of the US income tax, gains and losses realized on currency transactions are often considered ordinary income versus capital gains or losses.

Additionally, deductible foreign exchange currency losses beyond certain thresholds may also be subject to additional federal (and sometimes state) disclosure requirements.

Virtual currencies also carry tax implications. Virtual currency is digital money with real currency value and accepted as a means of payment by some individuals or institutions. A common type of convertible virtual currency is Bitcoin. Bitcoin can be digitally traded for US dollars, other types of virtual currency or other non-US currencies. For US tax purposes, the exchange of virtual currency is considered the exchange of property but not of foreign currency (even if held in a foreign account and considered a foreign financial asset). Whether this exchange is considered a capital gain or loss (including a nondeductible personal loss) or an ordinary gain or loss depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

If it is a capital asset (e.g. property, which includes investments), then the taxpayer may realize a capital gain or loss on its disposition. If the virtual currency is not a capital asset (e.g. used for transactions) then the taxpayer may 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.

Foreign trusts and estates

US persons who establish or are beneficiaries of foreign trusts may face unexpected tax consequences and significant reporting obligations. A US person 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 person to a foreign trust with US beneficiaries means the US person will be treated as the owner of the trust for income tax purposes.
US 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. Depending on the nature of the underlying assets of the trust and the frequency of distributions, US beneficiaries may face significant obligations (an additional interest charge, taxed at the highest tax rate) with respect to income tax on—and the reporting of—distributions received. Therefore, US persons 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 section) but may still require disclosure.

Uncompensated use of trust property

Frank, 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 Jose, Frank’s son, as the primary beneficiary. Jose is a US income tax resident. Every summer, Jose spends the month of August in the vacation home owned by the Trust. Jose 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 Jose did not pay FMV rent to the Trust to use the vacation home, he is treated as receiving a distribution from the Trust. Accordingly, Jose has a Form 3520 filing requirement for each year he uses the vacation home without compensating the Trust for its use.

Jose 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 Jose 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.
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 be tax-free within the US.

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 may 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.

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

Zhou 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.

Zhou designates his sister Leilei as the sole successor trustee. Zhou dies in 2016. Because Leilei is a nonresident alien, however, Zhou’s trust becomes a foreign trust as soon as Leilei takes over, which makes it subject to various foreign reporting requirements.

If Zhou 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 and/or residents have the authority to control all substantial decisions regarding the trust.
Receipt of gifts or bequests from non-US persons or entities

A US person who receives gifts from foreign persons or entities may need to report them if the money or other property received in a calendar year is valued at more than a threshold amount. For gifts from nonresident alien individuals and foreign estates, the threshold is $100,000. To calculate the threshold amount, a US taxpayer must aggregate gifts from different nonresident alien individuals and foreign estates if the US taxpayer knows (or has reason to believe) that those persons are related. For these purposes, a gift to a US person 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 person is also required to report gifts of cash or property valued at more than $16,388 for 2019 and $16,649 for 2020, from foreign corporations or foreign partnerships. Unlike the threshold to report gifts from nonresident alien individuals and foreign estates, the threshold to report gifts from foreign corporations or foreign partnerships is indexed for inflation.

Shift toward global transparency

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. It has entered into many bilateral agreements with foreign governments as a way to unearth previously undisclosed foreign assets of US taxpayers.

FATCA

The Foreign Account Tax Compliance Act (FATCA) is intended to help the IRS detect US taxpayers who use 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% withholding tax. FATCA also implemented a new reporting requirement for owners of specified foreign financial assets.
Voluntary disclosure

Recognizing that a substantial number of US taxpayers with offshore assets were not in full compliance with their filing responsibilities, the IRS took steps to 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. Various modifications were made to the program in subsequent years. On September 28, 2018, the IRS officially closed the OVDP program but continues to allow taxpayers to utilize its streamlined procedures.

The streamlined procedures are available to both US resident and nonresident taxpayers (but not nonresident aliens) who meet the eligibility requirements, which include being non-willful, or having had a good faith misunderstanding of the requirements, in their failure to report foreign income and accurately file US tax returns and information statements.

Under the Streamlined Domestic Offshore Procedures, eligible resident taxpayers are subject to reduced penalties for unreported foreign financial assets and accounts. Under the Streamlined Foreign Offshore Procedures, eligible nonresident taxpayers (which can include US citizens and green card holders residing outside the US) 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 streamlined procedures to file delinquent or amended tax returns to report and pay additional tax, may submit these additional forms through the Delinquent International Information Return Submission Procedures. Taxpayers who are eligible to submit any delinquent reporting forms through this method may file them 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 to come forward and comply.

Foreign information reporting

Foreign bank accounts are typical of offshore assets owned by individuals. 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). All reports must be filed electronically.

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 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. This form is due on April 15 with an automatic six-month extension available (to October 15).

After the enactment of FATCA, US taxpayers have been required 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 foreign bank accounts, 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).

For tax years after December 31, 2015, certain domestic corporations, domestic partnerships, and domestic trusts must also comply with the foreign asset disclosure filing. For domestic corporations and partnerships, two tests must 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 is advised 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.

**Common Reporting Standard (CRS)**

In 2014, the Organization for Economic Cooperation and Development (OECD) developed a standard for the automatic exchange of information (AEOI) regarding bank account ownership information with financial institutions between tax authorities from participating. Currently, there are over 156 countries participating in CRS. Similar to FATCA, the purposes is to combat tax evasion and avoidance. The US is not one of the participating countries; however, advisors should be aware of such reporting obligation when assisting clients from one of the 156 countries.
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). For US citizens, the reach of the US transfer tax system is fairly clear. The rules for noncitizens, however, are more complex. Residency for US income tax purposes is typically based on objective tests (e.g., 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 or has lived in the US and intends to stay indefinitely or intends to eventually return whenever absent. In addition, once domicile is established in the US, it cannot be terminated until the taxpayer establishes domicile in a new location. Therefore, simply departing the US without the intent to return is not sufficient to terminate US domicile.

Nonresident aliens and US situs property

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

This is in contrast to the US gift tax, which is imposed on nonresident aliens’ gifts of real and tangible (but not intangible) property situated in the United States if the value exceeds $15,000 or $155,000, in the case of gifts given to a non-US-citizen spouse in 2019 ($157,000 in 2020). Unlike US citizens and residents, nonresident aliens 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 alien 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 alien’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 nonresident aliens is the US gift and estate taxation of US real property, which is discussed at the end of this section.

4 Please see the Estate and gift planning section for an in-depth discussion of the US estate and gift tax system in PwC’s Guide to tax and wealth planning.
Residency test
What makes a person a US resident for purposes of the US transfer tax?

The residency test for the US (wealth) transfer tax is subjective as opposed to the residency test for US income tax, which is mainly objective. The residency test for the US transfer tax is based on an individual’s domicile as described below.

An individual will be considered domiciled in the United States if the person is living there and intends to stay indefinitely. Once established, domicile does not terminate until established in a new location. Departing the US without the intent to return is therefore not alone sufficient to terminate US domicile status.

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.

* This infographic notes just a few of the factors a court might consider in determining residency status.
The noncitizen spouse and the marital deduction

The noncitizen spouse presents special considerations in estate planning. As discussed in the Estate and Gift Planning section 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 a 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 ($155,000 for 2019 and $157,000 for 2020). 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 effectively 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 must meet certain criteria. The trust must have a US trustee, US estate tax must be paid on distributions of principal to the surviving noncitizen spouse, and the assets remaining in the trust are subject to US estate tax upon the death of the noncitizen surviving spouse.

While QDOTs can be created after death, 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 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

Tax treaties between the United States and other countries may further complicate the planning process. Currently, the United States has a number of estate tax treaties 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

US taxpayers may reduce their income, estate and gift tax liabilities 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, some differences.\(^5\)

The most notable difference is that gifts to certain foreign qualified charitable organizations that are not typically deductible for purposes of US income tax are deductible for purposes of US estate and gift tax.

Another 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.

\(^5\) For a more in-depth discussion of the rules for charitable giving and the related tax consideration, please see the Charitable giving section of this Guide.
Coming to the United States

Proper planning and structuring before establishing US residency can reduce exposure to US tax and can simplify future US tax reporting and compliance. Estate plans should be reviewed to examine the merits of structuring estates in consideration of foreign assets and non-US heirs and beneficiaries.

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 nonresident aliens 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 US life insurance to shield income from taxation.

The opposite approach may be warranted if tax rates are expected 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.

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.

Taxpayers should make sure their plans are regularly reviewed and updated by qualified advisors in order to minimize their US tax exposure.

Nonresident alien tax considerations

Real estate

The US income tax system contains numerous pitfalls for unwary nonresident alien investors, 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 before a nonresident alien individual purchases real estate. These ownership structures include direct ownership by a foreigner, a US company, a foreign company, a combination of both, a US or foreign trust, a US partnership 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, 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. Proper planning, ahead of the sale, can avoid excess withholding.

There may be planning opportunities to alleviate the estate tax burden of owning US real estate, but any potential estate tax savings must be weighed against income tax consequences.

**US equities**

While dividend payments from US corporations paid to nonresident aliens 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 unless the nonresident alien has a tax home in the US and is present for at least 183 days in the year of sale. Such assets, however, are considered US situs property for US estate tax purposes and therefore estate tax planning should be considered.

**Alternative investments**

For many nonresident aliens, 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 US nonresident aliens. Entering the fund through an offshore feeder will simplify US tax reporting for nonresident alien investors. US citizens or tax residents living outside the United States, however, should double-check that they have not inadvertently invested through the offshore feeder, as this can result in unfavorable tax consequences.

**Reporting obligations of nonresident aliens**

Nonresident aliens with US income or business activity (described earlier) may be required to file Form 1040-NR, US Nonresident Alien Income Tax Return. Nonresident aliens are not typically required to file the additional informational forms required for CFCs and other foreign entities (though certain forms may be required if an individual is classified as a nonresident alien only 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 December 2016, the IRS finalized proposed regulations that 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 regulations, which became effective in tax year 2017, can have a significant impact on nonresident aliens.

Leaving the United States

The United States has special tax rules for certain individuals who relinquish or renounce their US citizenship or terminate long-term permanent residency status (i.e., green cards). In general, the law imposes an exit tax on the deemed sale, vesting and disposition of worldwide assets of these “covered expatriates.”

Although there are certain exceptions, the law applies to US citizens and long-term US permanent residents who meet specified income or net-worth tests or who have not met US tax obligations for the previous five years. A 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.

In addition to seeking immigration advice, STOP and seek tax advice prior to obtaining or relinquishing your green card or moving outside the US while holding the green card, and prior to relinquishment or renouncement of US citizenship.
Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
Managing your investments

Developing an investment strategy that evolves with your financial goals is an integral component of wealth management. In this report, we cover topics such as asset allocations, different types of management fees you may encounter and special considerations surrounding investing in hedge funds.

A sound investment strategy balances risk and return and is flexible enough to capitalize on new opportunities as they arise. An investment plan brings the strategy to life. As goals often change over time, investment planning should be an ongoing process that has a long-term focus but easily integrates short-term needs, such as purchasing a vacation home. It is equally important to monitor your plan as conditions change. Recent tax reform, for example, may offer new options to increase your yield. In addition, you should assess current market realities such as the impact of rising interest rates on your portfolio.
Here are the steps involved in building a strong investment plan. Click on each to learn more about what’s involved at each step:

- Assembling an investment advisory team
- Establishing realistic, specific financial goals and assessing constraints
- Determining the right risk/return trade-off to meet your goals
- Determining the appropriate allocation and location of assets
- Developing your investment strategy
- Reviewing performance and rebalancing your portfolio accordingly
Assembling your investment advisory team

Your advisors should be trained and experienced in financial planning. Close communication between this team and your other advisors, such as your tax accountant and estate-planning attorney, will be necessary to ensure that the team is fully aware of your wealth management goals.

Members of your investment team may include:

- **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. Increasingly, these managers also need to possess expertise in digital developments such as blockchain.
- **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 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.

In addition, you may decide to designate a Trusted Advisor as a contact for your wealth managers. A Trusted Advisor is someone outside of your team of advisors who can be contacted by them if they suspect financial exploitation or are concerned about your health or mental state.

Selecting a team manager to work with you and your other advisors can streamline the management and execution of your investment plan. Ideally, the manager should also have broad financial planning experience and be knowledgeable about the dynamics of financial markets and current political developments. Data breaches, identity theft and other threats to the security and privacy of your investments increase the need for you to ensure that your circle of advisors includes someone with expertise in cybersecurity.

It is recommended that the team manager 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 ensure that there is a baseline of knowledge on your team, as do the fulfillment of continuing education requirements accompanying many of those certifications. 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 provide regular updates on your investments, noting any changes in your investment plan and explaining how they align with your wealth management goals.
Jeremy and Nicole are parents of a little boy, Jack. Already, Jeremy and Nicole are planning for Jack’s future, including his college education. They envision him 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 Jack’s college tuition.

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

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<td>Monthly contribution needed to fund cost</td>
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Establishing your goals and constraints

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

Don’t forget to factor in the constraints you face in implementing your strategy, such as dollars available to invest, risk tolerance, time horizon 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. It is important to monitor your advisors’ adherence to the IPS, benchmark the progress toward your goals, and revisit your IPS when your goals or circumstances change.

Determining the risk/return tradeoff

The biggest fear that investors face is losing money. However, investors cannot obtain a positive return after taxes, inflation and expenses if they do not take some risk. Thus determining the level that you are comfortable with is key to setting your strategy. 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 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 grows over time.

Required risk

A certain amount of risk is needed to achieve your investment goals. This is called required risk. For example, if you want to maintain your current lifestyle, you should run an analysis of your future cash flow, which may indicate that you’ll need to achieve an overall real return of 3% to meet your lifestyle goals.
Analyzing the required risk to meet your goals will help you quantify the requisite risk/return trade-off, 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.

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 3% 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 2% or less.

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

One common method of measuring risk capacity is the Monte Carlo analysis. This is a modeling approach that reveals all the possible outcomes of potential financial moves and assesses the impact of risk, enabling better decision-making amid uncertainty. The analysis involves running a set of assumptions through multiple simulations using random variables, such as rate of return, to measure the probable outcome. It 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. For example, 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 of large-loss scenarios. Your wealth management team should know how to run the appropriate simulations and draw reasonable conclusions.

Risk tolerance

An investor’s personal tolerance of risk is perhaps best described as the level of risk that one can withstand and still sleep well at night. Compared with required risk and risk capacity, risk tolerance is more subjective, since it involves the willingness to accept short-term losses in the effort to achieve a long-term return.

An investor’s risk tolerance can change over the years, particularly as the time horizon for achieving a stated goal narrows and the resilience of an investment portfolio wanes. 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.
Allocating 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.

But 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 or based on guesswork.

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.

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.

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

Your investment opportunities can cross borders

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

Diversification is an important way to mitigate risk when you invest internationally.
Asset-class selection

An Asset class refers to a grouping of 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 to create a portfolio return that will be less than the return of the best-performing asset class but above that of the worst-performing class. This approach ideally 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 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 deploying capital to those asset classes. This is accomplished by matching expected rates of return to a specified tolerance for risk.

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.”

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

- **Cash and cash equivalents** are investments that can be liquidated quickly, 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 appreciation or depreciation of an asset. These investments may include small company stock, “blue chip” corporate stocks, and certain limited partnership investments.
• **Alternative investments** refer to a wide range of non-traditional asset classes and may involve investing as a limited partner in either a hedge fund or private equity fund. The 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.). This type of fund is similar to a mutual fund, except that the fund trades like an individual stock. ETFs generally charge lower management fees than mutual funds, which has helped their popularity.

In addition, you may need to consider a different allocation for funds you set aside for retirement, education expenses, or other goals, due to the potential variations in investment time horizon and your associated risk tolerance for each goal.

**Sub-category allocation**

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 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 reduces interest-rate risk—because a portion of the bond portfolio will often be nearing maturity—and 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 such investments are not advertised to potential investors through conventional channels.

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. 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 the implications of each prior to investing, as the tax benefits and consequences can differ greatly. Here are some things to consider before investing in a hedge fund or private equity fund:

- 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?
- Have you factored for 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?
- Do you anticipate 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?
• Have you considered 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 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 at regular intervals 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 may 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 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 for meeting goals, such as retirement, don’t forget the basic rules of personal liquidity risk management: Having a liquid cash reserve available to pay living expenses in the event of a personal crisis or a down market. This liquidity also helps give you the ability to stick to your investment plan during down and volatile markets. It is generally 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 manager who can monitor your plan and coordinate the advisory team’s efforts will help you achieve greater efficiency and a reduced level of risk.
Achieving tax efficiencies through strategic asset placement

Given the scope of individual tax reform enacted in 2017, it is important to consider how the changes can affect your overall investment strategy and the location of those investments.

For example, **Opportunity Zones**—a program created by the Tax Cuts and Jobs Act of 2017 to promote growth within our nation’s struggling communities—creates ways for investors to defer taxes on capital gains. Taxpayers that have large gains should analyze reinvestment opportunities within Qualified Opportunity Funds (QO) to see if the incentives could provide benefits. Learn more about QOs

At the same time, several itemized deductions have been eliminated, including fees charged by tax preparers and investment planners.

The Effective Tax Planning section of this Guide discusses the top marginal income tax rates for various filers and how these rates changed under the 2017 reforms.

One way to mitigate potential tax impacts on your portfolio return is by achieving tax efficiencies via strategic asset location.

Essentially, **asset location** involves determining the best “place” for you to own a particular investment. 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.

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.

Which investments to own within these accounts depends on the investment purpose. 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 a more favorable tax rate if held longer than one year. Furthermore, stocks that pay a dividend generally are taxed at a preferential tax rate of 20% (assuming the taxpayer is in the highest marginal tax bracket). For these reasons, stocks that pay dividends have generally been held in taxable accounts.

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 your portfolio investment strategy

Now that you have achieved your desired strategic and tactical asset allocations, the next step involves developing an investment strategy to determine how best to deploy or redeploy your investable assets. There are several approaches available.

Active investing: Here the investor continually monitors 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 technique is generally more expensive than passive investing due to the increased administrative costs such as trading and management fees.

Passive investing: In this strategy, 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 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.

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

Reviewing your portfolio’s performance

Every year, you should revisit your allocation in light of changes in your personal profile, length of time to your next goal, your risk tolerance and your investment mix. If any of these factors change significantly, your asset allocation will 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 some of the excess gains from a portfolio’s highest return asset classes each year while purchasing additional positions in the lowest return 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 seldom repeat or maintain their strong performance. To illustrate this point, in 2012, Emerging Markets equities were one of the hottest asset classes. However, from 2013-2015, Emerging Markets equities consistently underperformed other asset classes. Given the dynamics and uncertainty of the market,
Rebalancing your portfolio

Making adjustments to stick with your original desired asset allocation

Investors rebalance their portfolios to make sure they stick with their desired asset allocation. In the example above, an investor determined their desired asset allocation to be 60% stocks, 30% bonds and 10% cash. However, over the course of the year, the investor’s asset allocation changed. This can happen due to a variety of factors, including different growth rates between stocks and bonds, or infusions of cash from liquidity events. The investor will need to make some adjustments to get back to the desired asset allocation by adding to the areas of the portfolio that have decreased in value and trimming in those areas that now exceed the initial targeted percentage.

Asset allocation models shown are for illustrative purposes only and should not be taken as recommendations. Please consult with your financial advisor for assistance in finding an asset allocation that is most appropriate for your situation.

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 to take into account more than just historical rates of return. Other important factors 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.
Dollar-cost averaging

**Dollar-cost averaging** is an investment technique whereby an investor purchases investments such as stocks, bonds, mutual funds, ETFs, etc., in fixed amounts over a regular period of time (e.g. monthly, quarterly, etc.). This strategy results in fewer shares being purchased when prices are higher and more shares when prices are lower. Several studies have shown the dollar-cost averaging investment technique underperforms other investment techniques in the long run, such as lump-sum investing. However, some investors may still value this technique for its simplicity. Further, dollar-cost averaging may provide an investor a certain level of comfort knowing that they didn’t invest all their investable assets during a market high.

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.

- **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, record keeping, 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 upfront when you invest in a mutual fund. It is in addition to the fund’s ongoing operating costs. For example, a mutual fund may charge you a 5% frontload fee for investing in the fund. If you invest $10,000, then $500 will be taken out of the investment up front, and the remaining $9,500 will be invested in the fund. This fund will have to generate a higher rate of return if it is to equal the return you receive from a no-load fund, assuming that all other fees are equal.
• **Deferred-load fee:** In contrast to a frontload fee, a deferred-load or redemption fee applies to certain funds if you sell them within a stated time frame. Such fees are 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**

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 as well as 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 end 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, 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 shortsighted 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 proven effective in managing risk and capturing reasonable returns—is a systematic asset allocation based on the time horizon associated with a particular investment goal. Short-term gains and losses are often generated with the end goal being a reasonable return over a given time period. Investors will usually define that return and that time period to best meet their end goals.
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.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
While few of us are likely to experience a disaster that has direct consequences for us personally, it would be 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.

Protection takes many forms. In this report, we discuss how you can safeguard you and your family from common financial scams and identity theft. We also break down the various ways to approach protecting your assets—both financial and physical. We cover considerations that can affect how well you are protected, such as forms of asset ownership that can include irrevocable trusts or limited partnerships. We also review the many insurance options from property and casualty to medical to long-term care and annuities. Life insurance has its own section: It remains important in estate-tax planning, even if less attractive for some families given the increase in the federal estate tax exemption in the 2017 tax reform.
Each year, increasing numbers of people are confronted with fraudulent schemes by those intending to obtain money or personal information. The federal tax system is increasingly a target of these efforts. Common tactics include impersonating an IRS official on the phone or via email to steal a Social Security number or other account information and filing fraudulent income tax returns to claim refunds. Victims also have had their mail forwarded to a criminal’s address without their knowledge and, with recent data breaches, have had their Social Security number stolen and used to set up fraudulent accounts. Perhaps most sinister is the surge in the theft of children’s Social Security numbers, which sometimes is not discovered until years after the theft took place.
Fraudulent tax return filings

If a criminal files a falsified state or federal tax return under your name, you will be alerted when:

- 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 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, false returns are filed early in the tax 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 an identity verification document (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 major credit reporting agencies. Naturally, the proper tax return must be paper-filed, along with copies of Form 14039 and the identity verification document.

Keep in mind, 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

Theft of children’s Social Security numbers

Identity theft has become even more sinister with the surge in the theft of children’s Social Security numbers. The types of scams are proliferating as well, including new variations of identity theft due to recent data breaches and email phishing.

What to do

It is important to freeze a child’s credit to safeguard against such theft. Many tax preparers have significant experience with identity theft targeting adults and can provide helpful information regarding the legitimacy of the correspondence, as well as assist in dealing with the IRS.

Telephone and email phishing

These calls or emails usually involve an aggressive assertion that a collection effort is underway in order to startle the victim into sharing personal identifying information such as a Social Security number or credit card data. Some emails have a link or attachment that contains malware designed to extract sensitive information from the computer’s hard drive. In a recent twist, phone scammers call you from what appears to be your own number, say your phone carrier has been compromised and ask for the last four digits of your Social Security number.

What to do

Know that brands don’t use robocalls to contact their customers. Don’t answer calls from numbers you don’t recognize or, in this case, your own. Even a simple ‘yes’ can be recorded and played back by a scammer wishing to impersonate you. If you receive a call or email, even if it looks and sounds legitimate, it’s best to look up contact information yourself and initiate the call or email. Never simply reply to an email or give information on the phone if you did not initiate the call and verify the number.

Find more information on business identity theft and some of the appropriate steps to take to protect company, employee, and client information in this report.
Asset ownership considerations

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. The form of ownership you choose will determine the degree to which those assets are at risk.

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 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, estate-tax savings trusts (e.g., credit shelter trusts) created in a will may not be funded appropriately. Joint tenancy ownership can also increase tax liability if the estate tax exemptions are not maximized. 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, but there are still circumstances where it could be an issue. Your estate planning team should have a complete understanding of the ownership forms used for your assets.
Assets held with others

As with marital joint property, these do not go through probate. They remain in the taxable estate of the original owner (i.e., are not deducted from the gross estate for tax purposes). 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 eligible for 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 (also referred to as a “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. 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 permit self-settled asset protection trusts. They 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, which are self-settled trusts created in another country (e.g., Bermuda or the Cayman Islands). The arrangements structured by professional groups that specialize in advising people about how to set up these trusts can involve 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 find more information on these forms and the related penalties for not filing in the “Cross-border tax considerations” section of this guide.

Combining an 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) because the creditor cannot monetize the assets owned by the LLC/LP unless they control the entity. 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 provides a layer of anonymity because the individual owner’s (of the LLC) name is typically absent from the public record. This strategy has gained the attention of 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 considerations

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.

And keep in mind, in shopping for new insurance or reviewing current coverage, be sure to assess the financial strength of the insurance carrier. Don't take for granted any particular insurer's ability to pay claims.

Property and casualty insurance

Property 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 who is knowledgeable about your assets 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 so you can cancel redundant coverage. Make sure 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 in the event of a lawsuit alleging 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, liability coverage is often linked to Federal Aviation Administration (FAA) rules that apply to the specific use of the aircraft. Be careful when insuring aircraft used for mixed purposes—partly for business and partly for personal activities. Coverage eligibility will depend on who owns the plane and who is using it. Placing ownership of an aircraft in a limited liability company can offer certain advantages, but it can also significantly alter or even invalidate liability coverage.
Health insurance considerations

There are three basic 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 the use of physicians within a specific network, offering less flexibility but lower costs. A PPO allows you to go out of the plan’s network, but charges a higher fee if you do. POS plans combine elements of an HMO and PPO. Starting in 2019, given changes to the Affordable Care Act, Americans are no longer required to pay a penalty if they have not obtained health coverage.

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 (HSA) 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, up to a limit of $7,000 for 2019, and both employers and employees can make contributions to the account (subject to an annual limit, which is adjusted from time to time). As discussed in the Effective Tax Planning section of the Guide, 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 some of 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 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: 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, which can be substantial, 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 considerations

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. Historically low interest rates have made immediate annuities more popular for people who worry that they will run out of money in 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.

The earnings are not subject to income tax until distributions from the annuity account occur. Generally, there is a 10% penalty applied if payments begin before the account holder is 59½ years old.

Individuals should carefully evaluate investment costs and historic rates of return, as with any other investment. Remember that the financial health of the insurance carrier making the annuity payments is a critical factor.
Life insurance considerations

Life insurance is an important component of an individual’s overall financial plan—particularly for purposes of estate-tax planning.

There is a wide variety of life insurance products. Insurance carriers continually add, remove and change policy features to meet the demands of a competitive market. 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 an 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 for 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?**
  In addition to individuals and businesses, many insurance policies also 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 may be 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 period
- **Permanent life insurance**, which provides coverage until you die (or cancel the policy)

### Common life insurance products

<table>
<thead>
<tr>
<th></th>
<th>Term</th>
<th>Whole</th>
<th>Universal</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary coverage</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Premiums</td>
<td>Fixed level for term</td>
<td>Fixed level</td>
<td>Flexible or fixed level</td>
<td>Flexible or fixed level</td>
</tr>
<tr>
<td>Guaranteed death benefit</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Builds cash value</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Access to cash</td>
<td>n/a</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Advantages</td>
<td>Easy to understand Least expensive</td>
<td>Predictable Tax-deferred cash accumulation Lifetime coverage Guaranteed cash value</td>
<td>Tax-deferred cash accumulation Flexible premiums and benefits</td>
<td>Tax-deferred cash accumulation Offers investment options Greater growth potential</td>
</tr>
<tr>
<td>Disadvantages</td>
<td>No lifetime coverage No savings feature</td>
<td>Lack of flexibility Higher premiums</td>
<td>Cash value depends on interest rate</td>
<td>Investment risk/loss potential</td>
</tr>
<tr>
<td>Purpose</td>
<td>Short to intermediate need</td>
<td>Lifetime protection</td>
<td>Lifetime protection (if cash value is sufficient)</td>
<td>Lifetime protection (if cash value is sufficient)</td>
</tr>
</tbody>
</table>
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**—This 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 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). In a low-interest-rate environment, the pricing for this type of universal life insurance becomes less competitive with more traditional types of policies.

- **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. The investment growth within the policy is income-tax free. Policy cash values can be accessed during life through policy loans (as long as payment requirements are met), 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 costs must be evaluated.
• **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 it’s unwise to dismiss it without doing some research and evaluating 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.

Families often have more than one breadwinner and may therefore need a life insurance program that provides coverage for multiple earners.

Traditional single-life products are appropriate for families who 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.
Estate tax considerations

The rise of the federal estate tax exemption will ease the need for insurance to cover that payment for many. However, for those with high net worth, the estate tax can still 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 the 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 spouses 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 purposes. For instance, they may want to ensure that they can:

- 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.

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.

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

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

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

When 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.
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, ownership of the business can go to the children who will be involved in managing it and life insurance can provide for the children who will not be running the family business. This can avoid potential family conflicts that can arise when some of the children acquire ownership in the business as absentee investors.

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. 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 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

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 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.

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 for the tax savings to 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 overseas investment professionals may not be 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.

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**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.

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**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).

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**What’s not clear**

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.

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*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.

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* 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.
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 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

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.
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 time to make informed decisions about insurance policies and types of asset ownership, you can better mitigate the risks to your health and wealth.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
While they may differ greatly in form and function, family offices owe their formation to a common, straightforward rationale: to facilitate the wealth planning of a family so that its short-term needs are adequately met in tandem with achieving the family’s long-term goals.
A family office is an organizational construct for managing and overseeing wealth and preserving the family legacy. Families take this step to coordinate services such as estate and tax planning, legal and investment advice and other administrative activities in one place, often for a single family client to maximize privacy and efficiency.

As more families form or join a family office, many institutions have introduced or expanded their offerings to support them. A broad range of family office services is now available from a variety of providers. While choice is beneficial, determining the appropriate level of service and right type of provider has become complex. There are many alternatives to consider.

In this section, we will cover the following considerations:

- Different legal and tax structures available to the family office
- The income tax implications associated with those structures
- The limitations associated with a family office

We will also suggest some ways to address common challenges facing families that choose to create family offices.
Families are experiencing significant change across a number of dimensions

<table>
<thead>
<tr>
<th>Changes impacting families</th>
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</thead>
<tbody>
<tr>
<td><strong>Professional affiliations</strong></td>
</tr>
<tr>
<td>• Families are finding it harder to “go it alone.”</td>
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<tr>
<td>• Collaboration increasing among family offices and associations.</td>
</tr>
<tr>
<td><strong>Institutionalization</strong></td>
</tr>
<tr>
<td>• Families are organizing and formalizing activities into a family office environment.</td>
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<tr>
<td>• Focus on best practice standards and controls.</td>
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<tr>
<td>• Service providers are consolidating.</td>
</tr>
<tr>
<td><strong>Technology</strong></td>
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<tr>
<td>• Technology is empowering, evolving and aiding.</td>
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<tr>
<td>• Younger generations often want more mobile/digital information.</td>
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<tr>
<td>• Increasing concerns around data integrity, cyber security and disaster recovery.</td>
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<tr>
<td>• Landscape is continuously evolving.</td>
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<tr>
<td><strong>Managing external relationships</strong></td>
</tr>
<tr>
<td>• Increased outsourcing to service providers that requires due diligence, oversight, and management.</td>
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<tr>
<td>• Financial controls, risk management, and transparency in general.</td>
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<tr>
<td><strong>Investment considerations</strong></td>
</tr>
<tr>
<td>• Widening interest in investing in sustainable or impactful ways.</td>
</tr>
<tr>
<td>• Understanding opportunities and risks in direct investing alternatives, e.g. private equity, venture capital or real estate.</td>
</tr>
<tr>
<td>• Increasing demands for transparency and analysis.</td>
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<tr>
<td><strong>Generational shift</strong></td>
</tr>
<tr>
<td>• Younger generations integrate personal values, creativity with investment strategies.</td>
</tr>
<tr>
<td>• General wealth transfer is creating challenges to strategy, implementation, and measurement.</td>
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<tr>
<td><strong>Charitable giving</strong></td>
</tr>
<tr>
<td>• Increased emphasis on social responsibility is advancing philanthropic structures and activities.</td>
</tr>
<tr>
<td>• Charitable giving strategies and wealth transfer objectives need to be synchronized.</td>
</tr>
<tr>
<td>• Regulations are resulting in the need for clear documentation of assets transferred to charities.</td>
</tr>
<tr>
<td><strong>Globalization</strong></td>
</tr>
<tr>
<td>• Professional managers and advisors help manage global family wealth and affairs.</td>
</tr>
<tr>
<td>• Increased collaboration among high net worth families.</td>
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<tr>
<td>• Global operational models and crossing geographies and entities.</td>
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</tbody>
</table>
Managing certain administrative tasks with internal staff can be more private and less expensive than contracting with a provider

How family offices are formed

Family offices are created and evolve in a number of different ways. In some cases, the office will emerge out of the administrative services that support a family-owned business, which are also used to support family members. These can include tax and legal services and bill paying, and can extend to more personal services like travel arrangements or vehicle maintenance. For income tax purposes, as long as personal services are de minimis, the expenses are often treated as operating expenses of the business. As personal services become more significant, the company should consider disallowing a percentage of the related costs or treating them as compensation to the family members being served.

In other cases, the administrative services are delivered by an external provider, traditionally a bank and/or law firm that offers trust services to wealthy individuals. Trust services typically include investment management, tax and legal services and bill-paying. The services are available to trust beneficiaries and others.

More recently, investment advisory firms have added services specifically for family offices. For income tax purposes, most fees charged by the advisory firm for such services are treated as investment management fees, which are no longer deductible after the 2017 Tax Cuts and Jobs Act.

The evolution of the family office often accelerates when the operating business is sold or the wealth creator steps aside to concentrate on managing his or her own wealth. The support system should be amended or adapted, giving the family an opportunity to review the different types of family offices and make a decision about the right structure for their needs.

Regulatory oversight factors

Institutions that provide investment advice are subject to regulation by the Securities and Exchange Commission (SEC) or other regulatory body. In particular, the Dodd-Frank Act of 2010 defined the parameters under which an investment firm must register and report to the SEC. There is a special exemption for single-family offices. Family offices that support multiple family groups must register with and be regulated by the SEC. This regulatory distinction highlights the parallel evolutionary paths to the family office.

Services: outsourced or internal

Managing certain administrative tasks with internal staff can be more private and less expensive than contracting with a provider. On the other hand, some services require expertise that may be prohibitively expensive to replicate. For example, specialized tax preparation and estate planning services are often contracted out while the tax data gathering and estate monitoring and administration activities are kept in-house.
In many cases, internal staff will focus on specific functions that are most important to the family and are aligned to the staff’s particular skill set and experience. Some examples of this would include:

- **Administrative office:** Such offices typically focus on the organization and may consist simply of a bookkeeper and an assistant to provide concierge services.

- **Compliance office:** Many family offices are led by an accountant or attorney, perhaps someone who was formerly CFO of the business, and focus on taxes and tax compliance services. The office may include estate tax planning and bill monitoring services. Such offices frequently outsource investment management services.

- **Investment office:** Another common type of office is led by an investment professional, concentrating on growing the family’s assets. They may trade (or outsource trading) marketable securities, buy private companies or perhaps manage real estate. Such offices may outsource tax compliance and estate planning activity.

- Some offices perform all these activities.

**Limitations**

The self-contained family office provides exceptional privacy but runs the risk of perpetuating outdated ideas, techniques and practices. Offices that contract out services are more likely to encounter fresh ideas or new ways to implement existing ideas.

Family office exchanges, often run by education institutions, were created as an attempt to bridge this potential knowledge gap (much like professional education for tax and estate planning advisors).

**What structure is best?**

**The answer is—it depends.**

The structure of a family office is based on a range of factors including: tax, liability, investment, privacy and ownership considerations. In order to determine the best fit for your family, we recommend a thorough discussion with tax and legal advisors.

Each of the following structures have specific advantages and drawbacks that should be carefully considered and prioritized. That said, here are the most frequently used alternatives:

- **The embedded family office.** This is often the most cost-efficient way to provide family office services. The bill-paying, technology support, and other support services of the operating business are also called upon for family office activities. However, as family needs and desires for privacy increase, many families outgrow this type of arrangement.
• The standalone family office. This arrangement is usually organized as a partnership/LLC or S corporation, but may also be a C corporation, particularly after 2017 tax reform. The entity is often owned by a senior family member or a group made up of the oldest family members. The family office expenses are usually treated as investment related expenses. If the family office is in flow-through form (e.g. partnership, S corporation), the expenses would flow to the owners’ personal income tax returns. This is the most popular structure for family offices, but since the 2017 Tax Cuts and Jobs Act eliminated the deduction for investment related expenses for individuals, many family offices are evaluating a more tax efficient structure.

• The investment fund complex. This arrangement is organized around a C corporation or partnership/LLC with feeder investment pools (most often organized as partnerships or LLCs). The family office is often compensated via a profits interest or management arrangement with the underlying investment pools they manage. This can provide a slightly more tax-efficient structure but comes with significant complexity and ongoing operational tax management.

• Trusts. One or more trusts may be involved in the ownership of the family office and specifically contract for services with the family office. Embedding the family office within a trust (or group of trusts) can sometimes create conflicts of interest among service recipients who may or may not be trust beneficiaries.

• The private trust company. This is a perpetual entity that is legally authorized to act as trustee for family trusts and provide additional services (financial and otherwise) to the family (with resulting state and federal regulation). Rather than contract with an institutional trustee, the family creates a private institutional trustee.
The Family Assembly is the broad group of all family members. Some families define a minimum age for participation and may have other guidelines (such as whether to include in-laws) for inclusion in the Assembly.

**Family council**
- Family office
- Philanthropic committee
- Audit committee
- Investment committee
- Education committee
- Next generation committee
Governance often starts with a Family Assembly and Family Council

Governance

The single-family office, like the family-owned business, has unique governance issues that spring from the dynamic of blending family and business relationships.

Some family offices (and family businesses) create an outside “board” of trusted advisors that interact with a Family Council over the family office (or business). Extended families are more likely to have governing boards and committees, guiding different aspects of the family office (or business). This allows for broad input and involvement from multiple members while keeping responsibilities discrete in an effort to minimize conflicts.

Governance often starts with a Family Assembly and Family Council. Family Assemblies provide the opportunity for the broad family to participate, learn and provide input and feedback. Depending on the individual family, the Assembly may include spouses, stepchildren and long-term significant others. The Family Council is the governing group for the family and is often a representation of the branches and adult generations. This group may then create subcommittees to handle strategic planning, investment planning, charitable giving, technology needs, transfer of wealth and decision-making for the next generation, etc. The subcommittees report to the governing group and make recommendations.

Services

Some family offices focus initially on managing investments while others are primarily concerned with tax data collection or property management. However, over time, the list of services provided to family members often grows. These services are all designed to more effectively meet the needs of managing wealth. Below is a list of the most common service offerings we have observed in various family office structures.

Technology

Clients often ask what the best technology platform for a family office is as if there were just one or two types of technology. Most offices require a combination of accounting, investment and reporting tools as well as various support tools.

The specific tools vary greatly based on the types of investments, key activities and skillsets of personnel, and the needs and desires of the family and its staff. Also, it is important to consider the need for the family office platforms to interact with outside partners in choosing the appropriate tools.
# Range of services for family offices

## Operations
- Recordkeeping
- Reporting
- Bill management
- Property management
- Cash management
- HR and talent management

## Technology
- Network/IT support
- Cybersecurity
- Account and investment systems
- CMR, document management
- Data management and reporting

## Enterprise
- Oversee family businesses
- Manage real estate
- Business governance
- Philanthropy
- Family communication and meetings

## Compliance
- Tax planning and returns
- Insurance
- Property management
- Legal services
- Security and safety

## Succession
- Create estate plans
- Serve as trustee
- Organize training
- Leadership succession planning
- Wealth transfer planning

## Investments
- Analyze market outlook
- Investment management
- Due diligence
- Governance
- Risk, performance and analytics

## Legacy
- Family vision and charter
- Strategic planning
- Family governance
- Concierge services
- Education plans
Family offices should be proactive in educating next-generation family members on all matters

Common challenges and strategies to address them

PwC has identified 10 key challenges that many family offices face today. We believe families should deliberately consider each of these items, whether they are setting up a new family office or conducting strategic planning for an existing one.

1. **Succession:** Prepare the next generation of family and non-family leaders to lead the business, run the family office and properly govern entities and trusts. Work with family members individually to prepare personal development plans that match their interests, goals and needs.

2. **Cybersecurity:** Create policies addressing social media use, public Wi-Fi access rules, identity protection and minimizing risk involving the Internet of Things. Family offices should be proactive in educating next-generation family members on all matters related to privacy regarding individuals, assets and legacy to understand the impact to themselves and the family as a whole.

3. **Internal controls:** Strengthen internal controls that ensure proper money movement safekeeping, approvals and processing, investment transactions, vendor management and disbursement of funds to and from family members. Family offices should be open to sharing best practices to ensure that proper controls exist and are followed consistently and appropriately.

4. **Technology:** Evaluate the latest developments and consider potential efficiency and effectiveness improvement through enhanced automation, while considering the interests and goals of the younger generation. This includes accounting software, data aggregation and reporting tools, global custody relationships, interaction with investment advisors and more.

5. **Communication:** Develop a multipronged family communication plan that recognizes family members’ different communication styles, and potential need to hear messages multiple times in various ways. Many family offices have employed the use of family meetings to allow all members of the family to have a voice.

6. **Talent:** Help families come up with a plan to incentivize family members to work in the business and to retain non-family members as key leaders. It is essential to create a plan for attracting and retaining the right talent.
7. **Global tax**: Plan for the most tax-efficient structures, maximizing credits and deductions and minimizing income tax. With so many family offices now having a global reach and tax laws around the world in flux, this is imperative.

8. **Innovation**: Regenerate the family wealth, leveraging family intellect and ingenuity. Use creative ideas to build the family brand.

9. **Strategic philanthropy**: Assess the family’s philanthropic goals. Philanthropy has become much more than giving to a specific charity. Does the family have a common mission for their giving? Is there a mechanism to effectively measure the impact of their support? Connecting mission to impact to measurement is critical.

10. **Governance**: Create governance that allows the younger generation to steadily move into leadership while supporting the family’s desire for unity and cohesion. Governance issues cross over to all entities such as trusts, corporations and family partnerships. Having a plan in place to assist trustees, board members and partners is essential to smooth operations. Teaching the family legacy that led to the creation of the family wealth to younger generations is key to developing a proper family governance structure.
The precise nature and balance of a family’s 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.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
Family businesses tend to be closely held, with one or a small number of shareholders maintaining control over the enterprise and the family’s investments. While this type of operating structure has many advantages, tight control can also lead to challenges with a transfer of ownership and responsibilities. Managing succession is a key component of business continuity planning yet it can be a daunting task. As a result, some families ignore the need to formalize a plan or they postpone the process. While their intention may be to avoid conflict, a lack of information about succession can signal uncertainty, with potentially adverse effects on both the near and long-term health of the company. For example, there are usually other parties who are deeply invested in the success of the business, including customers, suppliers and employees. For them, the question of who will own and run the business in the future matters. A clearly communicated plan can assure all stakeholders that the business is here to stay.
There are many different ways to pass the family business to the next generation, but it is important to start by understanding your family culture and values, and defining a common purpose. This can help unite the family inside and outside the business. In this report, we discuss:

- Different approaches to succession planning for a family business.
- Strategies that we’ve seen successful families take to promote continuity within the business and the family.
- Effective ownership structures. Thorough succession planning should consider this, as family businesses can be organized in a variety of ways. These range from the relatively simple form of sole proprietorship to a more complex corporate structure.
- Considerations for a sale of the business, as this can be another outcome of business continuity planning.
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 these situations, the owner tends to maintain voting control, usually for his or her lifetime. This consideration, 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.

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 sooner rather than later, when options may be more limited.

Continuing the family legacy

Establishing a common purpose

Shareholder retreats and family gatherings can be forums for instilling the values of the business in younger generations and non-participating shareholders. A positive legacy can also be cultivated through the manner in which the company interacts with customers, employees and the community—establishing a well-known company philosophy. Once established, the family will be in a better position to choose the succession strategy or strategies that will get them closer to this vision for both the family and the business. Questions that families should consider include:

- Who are the key stakeholders in the family and the business?
- What is the family’s vision, not just for the near term but for the next 50 or 100 years?
- How does the family define its legacy?
- What is the long-term strategy for the business?
- How does each stakeholder define success of the business?

Succession plans should be informed by the family’s longer term vision and strategy. This will help determine what skills are needed and the type of leaders the company will need to get there.

1 Just 18% of US family businesses say they have a robust and documented succession plan: US Family Business Survey, PwC, 2019.
Paving the path forward: leadership, board and ownership succession

There are certain basic but critical steps that should be taken to promote continuity within the business and the family. Too often, however, such steps are skipped or postponed. A sense of urgency is crucial as someone will need to take the reins if the business owner unexpectedly becomes unable to lead the company. Early planning will ensure that a family’s succession strategy is flexible enough to adjust course as circumstances change.

The sections outlined below highlight three types of succession:

1. Leadership succession  
2. Board succession  
3. Ownership succession

Each type of succession should be considered as a business owner determines whether passing the business on to the next generation is 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 desired and realistic goal, there are ways to improve the odds of achieving that.

1. Leadership succession

The goal of leadership succession planning is to minimize the disruption to your business while maximizing the number of qualified candidates for future consideration. Succession planning in family companies becomes particularly complex as the family grows and ownership is handed down over generations. Many who work in and with family businesses point to the transition from Generation 2 to Generation 3 (G2 to G3) as among the most challenging. Why? Because there are typically more members in G3, raised in different families with different influences and experiences and perhaps different values. The G2 to G3 transition is often the point where family businesses put more formal leadership succession processes in place. Although this section highlights steps for CEO succession, formal succession processes should cover all key executive roles (e.g., CFO, COO, CTO, etc.).

It’s important to emphasize that succession is best handled through long-term strategy, not tactically at the time when the successor is needed. When planned over five to fifteen years, the family can identify a variety of candidates—family and non-family—giving them training and opportunities to grow. The best candidate often becomes obvious over time.
Determining successor requirements

When looking for the next CEO, you first need to define what skills and attributes will be essential to lead the business in the future, and how the new CEO will be chosen. You’ll then select the candidate who best meets the criteria and fits with the company’s culture. You can define baseline job standards for each role (college degrees, specific credentials and internal and external experiences) and require that all job-seekers, including family members, meet those standards.

Identifying potential successors

While the succession planning process may consider candidates from outside the family and the company, in many cases it focuses on managers who are already with the company. It considers these internal candidates’ business skills, leadership skills and experience as well as what development, mentoring and additional know-how they need. Effectively developing bench strength in the management pipeline will give your company more internal candidates. Such grooming allows them to step into various key positions and to be well-positioned for an opportunity to be selected as the new CEO when the time comes.

If a family restricts succession to family members, it may not have someone ready to step in as CEO and may exclude candidates who bring vital skills to the role. Highly qualified executives may choose to leave the company if their advancement is barred. The bottom line: family-only succession may not lead to the best successor CEO.

Promoting an executive from within the company has distinct advantages. The founder/CEO and the board know the candidate’s strengths, weaknesses and accomplishments. The executive understands the company, the industry and the culture and already knows customers and employees. And importantly, he or she likely has relationships with and the trust of the family.

If there are no capable executives or family members ready to step into the CEO role, the next step is to recruit outside. Even when there is a good internal candidate, it can be useful to understand what talent is available outside the company.

The succession choices faced by the controlling leadership break down according to the following considerations.

A family member should be considered as the next CEO when:

- He or she (whether in the current leadership generation or a successor generation) has the aptitude, is appropriately qualified and wants the position,
- The controlling owner(s) supports this family member as the new CEO, and
- The family and the board also support the selection of this family member.
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**

18% of US family businesses say they anticipate an ownership change within approximately 5 years.

What sort of changes do they anticipate?

- Pass the business on to the next generation to own and run 48%
- Pass the business on to the next generation to own but not run 26%
- Sell the business 19%
- Don’t know 7%

Expose them to strategy development, product development, finance and marketing

A non-family CEO should be considered when:

- The business needs an outside CEO to bring new ideas and processes.
- No family successor is qualified and willing to take the position.
- The family no longer wants day-to-day responsibility for the business.

A family member wants the position but is not yet ready to take over. To help prepare that individual, you might select a non-family CEO to run the company for a period, and charge that person with coaching/mentoring the family candidate for future leadership.

Preparing the next generation

If it’s important to keep company leadership in the family, focusing on executive training to develop expertise among its members should be a priority.

1. Identify an executive to coach them about the company, its industry and other aspects of the business.
2. Expose them to strategy development, product development, finance and marketing—as well as operations—to give them a well-rounded foundation. Consider rotating them through various positions in different business units across the company.
3. Assess their skills, aptitudes and interests periodically and identify where they need additional development.
4. Invite them to observe—and possibly present—at board or board committee meetings so they can see how the board operates and understand its role. This also gives them exposure to board-level issues that can help in their personal development.
5. Encourage them to be entrepreneurial. Some companies give younger family members a budget to pursue some of their own ideas within the company—allowing them to develop important business skills by implementing an idea they conceived.
6. Expose them to community activities the company may be involved in and encourage them to participate in organizations that support high-potential executives. Bring them to industry-related conferences, events for family businesses or even governance conferences to expose them to broader issues.
7. Involve them with the family council (if one exists) so they understand that group’s role interacting between the company and the family.
Roles of non-family executives

Sometimes an interim CEO is hired to run the company while preparing a family member to take the CEO position at a future point. An interim CEO in this type of role might be someone whose career is winding down but who is not yet ready to fully retire. In these cases, expect to negotiate a different employment package with the interim CEO than you would for a permanent replacement—which may include a different compensation structure that aligns to the shorter-term nature of the role.

Another option we see in emergency succession situations is to have a board director step in to run the company until the board can find a permanent CEO.

Choosing a successor

Choosing a successor and communicating that choice sooner rather than later not only demonstrates a commitment to keeping the business going, it also helps prevent surprises within the family and among other stakeholders. Ideally, succession decisions should 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 family members don’t agree with the owner’s choice.

If a successor is named, other members are more likely to take advantage of different career opportunities rather than sustain a sense of false hope (which 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 and can build their skills and relationships toward that goal.

Examining your board composition and future needs

Board members with multiple industry perspectives can prove helpful when navigating the vast amount of change businesses are faced with today.
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.

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.

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.

There are a number of ways to refresh your board. One way is to think about diversity of thought and perspective. Many have focused on building diversity into their boards and are looking to balance gender, race, ethnicity, skills, experience, expertise, age and even geography. This diversity helps ensure that boards are well-positioned to represent a broad range of viewpoints to best guide the company into the future.

Across many industries, business models are changing, competitors from different industries are appearing and new skills are needed. The picture of what your industry looks like today may be quite different in just a few years.
Many factors should be considered in choosing the best structure for a particular family’s business

If your company is shifting gears and changing the way it does business, it may be smart to take a fresh look at your board composition at more frequent intervals. Some boards use a skills matrix to see what they might be lacking in their board composition. So how do you fill the holes in the backgrounds or skills you want from your directors? It’s important to think about your board’s composition proactively. Use board evaluations to understand which directors have the necessary skills and expertise as well as those who lack those skills. Think about your board holistically as you think about your company’s future. Your board composition is critical to ensuring your board is effective and is keeping up with the world outside the boardroom.

Bringing on new board members

Once the company has determined the future needs of the board, recruiting new members should look very similar to the process for determining leadership succession. It’s important to identify who will be a part of the selection process, scope out the open board position(s), and screen and interview candidates. Once the final selections are made, the Board should have a plan for transitioning and developing new board members to make sure they understand the company, the industry, the culture, its customers and employees.

Ownership succession

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 choosing the best 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.
**Tax considerations:** It is important to weigh tax factors when determining the right ownership structure, including:

- What tax bracket are the principal owners in?
- 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 takes the potential for tax at two levels—the entity level and the ownership levels—into consideration. 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. Each family should consider many factors before making a change that is driven by tax reform, so consulting with your tax advisor is imperative.
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.

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**Business ownership agreement**

Put one in writing to help avoid family disputes

Sam, Ian, and Rebecca are siblings who own an S corporation; each holding one-third of the company's stock. Sam and Rebecca 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 Rebecca 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 Rebecca 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 successful transition almost always hinges on a well-considered, written plan that clearly specifies the disposition of ownership interests in the business

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 and communicates 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, will increase the likelihood of a successful transfer of the ownership interests.

In addition, a business owner may 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 critical. 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.

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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 the Risk Management section of this Guide.
A number of options for lifetime transfer planning should be modeled and considered for inclusion in a succession plan

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 the ramifications 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. It should be noted that estate and gift tax reform has provided a new opportunity in this area—an increased lifetime tax exemption to $11.4 million for individuals ($22.8 million for married couples).* Consulting with your tax advisor is recommended.

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

A new deduction for qualified pass-through business income is effective for tax years beginning after December 31, 2017. The pass-through entity’s operating agreement would provide a 20% deduction for qualified business income from a partnership, S corporation, or sole proprietorship. The 20% deduction combined with a top ordinary income tax rate of 37% for individuals would result in a top rate of 29.6% for such income in the absence of other limitations.

Business losses in excess of business income plus $500,000 (married filing a joint return) are not deductible starting in 2021. Such losses will be treated as net operating loss (NOL) carryforwards to subsequent taxable years. This limitation will apply after the application of the passive loss rules under Section 469. It will limit the ability of taxpayers to use large business losses to offset other income in their returns (e.g., wages, interest, dividends, capital gains). These new rules are very complex and will need to be discussed with a tax advisor before any restructuring is done.

The amount of interest expense that businesses may deduct on their tax returns is temporarily increased from 30% to 50% of adjusted taxable income for any tax year beginning in 2019 or 2020. A taxpayer may make an election not to have these rules apply. A taxpayer also can elect to use its 2019 adjusted taxable income in computing the 2020 excess business interest limitation for all businesses, including partnerships.

* Updated exemption figures on March 12, 2018.
<table>
<thead>
<tr>
<th></th>
<th>Partnership</th>
<th>S corporation</th>
<th>C corporation</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liability</strong></td>
<td>Unlimited for general partners</td>
<td>Limited to amounts invested and loaned</td>
<td>Limited to amounts invested and loaned</td>
<td>Limited to amounts invested and loaned</td>
</tr>
<tr>
<td><strong>Double taxation</strong></td>
<td>No</td>
<td>No (except for some built-in gains and passive income)</td>
<td>Yes</td>
<td>No, unless election made to be treated as a C corporation</td>
</tr>
<tr>
<td><strong>Flow-through of profits and losses</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes, unless election made to be treated as a C corporation</td>
</tr>
<tr>
<td><strong>Limitation on entity losses deductible by owners</strong></td>
<td>Net investments plus net income plus share of debt</td>
<td>Net investment plus net income plus loans to corporations</td>
<td>None deductible</td>
<td>Net investment plus net income plus share of debt</td>
</tr>
<tr>
<td><strong>Subject to passive activity loss rules</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Only certain small C corporations</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Tax rates (pre-Tax reform)</strong></td>
<td>Income taxed to owners at marginal tax rates, plus 3.8% on investment income*</td>
<td>Income taxed to owners at marginal tax rates, plus 3.8% on investment income*</td>
<td>15% on first $50,000, increasing to 34% over $75,000 and 35% over $10 million**</td>
<td>Income taxed to owners at marginal tax rates, plus 3.8% on investment income*</td>
</tr>
<tr>
<td><strong>Special allocations</strong></td>
<td>Possible, if there's a substantial economic effect</td>
<td>No</td>
<td>Possible, if tracking stock is issued</td>
<td>Possible, if there's a substantial economic effect</td>
</tr>
<tr>
<td><strong>Fiscal year</strong></td>
<td>May be the year-end of majority interest or principal partners; alternatively, may be the tax year that provides the least aggregate tax deferral</td>
<td>May end up to three months earlier than the year-end of principal shareholders</td>
<td>New corporations—any fiscal year; Existing corporations—fiscal year with business purpose; automatic change permitted in certain circumstances</td>
<td>May be the year-end of majority-interest or principal partners; alternatively, may be the tax year that provides the least aggregate tax deferral</td>
</tr>
<tr>
<td><strong>Tax-free fringe benefits to owners</strong></td>
<td>Limited</td>
<td>Limited</td>
<td>Permitted</td>
<td>Limited</td>
</tr>
<tr>
<td><strong>Public offering</strong></td>
<td>Yes, but with some complexity</td>
<td>No</td>
<td>Yes</td>
<td>Yes, but with some complexity</td>
</tr>
<tr>
<td><strong>Tax-free merger with corporations</strong></td>
<td>Yes, under certain circumstances; additionally, possible tax-free incorporation available</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, under certain circumstances; additionally, possible tax-free incorporation available</td>
</tr>
<tr>
<td><strong>Accumulated earnings tax</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Personal holding company tax</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

* 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.

** 21% flat rate for tax years beginning in 2018.
The successful transfer of a family business is never a purely organic process. It requires a series of intentional, sustained and well-coordinated planning efforts. That’s because leadership, board and 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 or board transition or ownership change, delivering lasting value to the family and other key stakeholders for generations.

You can find more insights on creating formal processes to help your family enterprise successfully navigate today’s business world in our Governance for family businesses series.

Topics covered in the Guide reflect conditions at the time of publication. Please consult your financial advisor to stay abreast of current rules and considerations for managing your wealth.
In today’s complex world marked by interdependent markets, global interests, and changing tax requirements, it can be difficult to have confidence and peace of mind when it comes to your financial life. PwC’s Personal Financial Services practice understands this and the unique challenges you face in managing your wealth and planning for the future.

The professionals in our practice offer the judgment, experience and capability required to help you achieve your goals now and for future generations. In addition, we team across the firm to provide a robust portfolio of private wealth services to better serve the sophisticated needs of high-net-worth individuals and families.

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- Investment planning
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- Philanthropy
- Insurance and risk management
- Succession planning
- Family offices
- Lifestyle (unique) investments
For more information on the concepts and strategies discussed in this guide, please visit pwc.com/pfs or contact a professional in our Personal Financial Services practice.