

Managing your wealth

*Guide to tax and
wealth management*

2013



Managing your wealth
Guide to tax and wealth
management



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Certainty in an uncertain world: That is the goal of sound wealth management. Continued economic and political volatility, both here and around the globe, has made that goal an especially pointed one in recent years — not to mention challenging, if you don't have the right guidance.

This book aims to provide that guidance. It is written in the firm belief that high-net-worth individuals and their families need to play an active role in their wealth management, asking advisors the right questions and reviewing their answers regularly.

Asking the right questions requires a solid understanding of wealth management principles and how to apply them in a variety of areas, ranging from personal tax planning to the transfer of a business. Equally important is the need to share that understanding across generations so that the ability to protect the family's wealth and steward it into the future does not rest solely with one person.

Put simply, wealth management should be a family enterprise. When taking this approach, senior family members view matters of legacy and wealth preservation as something to plan *with* the next generation, rather than something to plan *for* it. Junior members will ultimately be the ones responsible for realizing the family mission — obtaining their input should increase the likelihood that the mission will go as planned.

That mission will be pursued in an increasingly interconnected world. The success of a family business or the longevity of a family foundation will depend partly on the junior generations' understanding of geopolitical and economic dynamics around the globe. Younger members will also need to be alert to how tax policy and regulation in various countries may affect the family's wealth management plan now and down the line.

In the relatively near term, tax policy here in the United States may shift in ways that have a far-reaching effect on the growth and endurance of family wealth. That, coupled with the impact of other governmental efforts to tackle federal and state deficits, will make it necessary to take a fresh look at your wealth management plan.

High-net-worth individuals and their families need to play an active role in their wealth management, asking advisors the right questions and reviewing their answers regularly.

The best way to revisit your wealth management plan is through candid, cross-generational meetings within the family, and then with advisors. The better that you, as a family, define and agree on a set of values and wealth management goals, the more effective your advisors can be in helping you navigate the changes ahead. Likewise, the more you understand the wealth management strategies that are designed to help you prepare for and adapt to fluid conditions, the better you'll be able to work with your advisors in adjusting your plan's compass.

Assisting you with these endeavors is the main objective of this guide. Here you will find a detailed summary of the key concepts and approaches pertaining to tax planning, investing, charitable giving, estate and gift planning, business succession, family meetings, family offices, and risk management. I encourage you to use this guidance as the basis for an engaged dialogue with your advisors so that you are as involved in your wealth management planning as they are.

Each chapter in the current edition has been updated for the latest legal, economic, and legislative developments. This year, global considerations have been threaded throughout the chapters as well, reflecting the international diversity of high-net-worth families and the cross-border factors affecting their wealth.

I hope that you will find this guide useful in the months ahead, consulting it not only during tax planning season, but also throughout the year as you look to create lasting value for you and your family.

Sincerely,



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

A man with dark hair, wearing a light-colored short-sleeved shirt, is looking back over his right shoulder towards the camera with a slight smile. He is seated at a table. In the background, two women are seated at the same table, looking towards the camera. One woman has blonde hair and glasses, and the other has dark hair and glasses. They appear to be in a professional meeting or office setting. The lighting is bright, suggesting a window nearby.

*Effective tax
planning*



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

Although the federal tax code remains essentially unchanged for 2012, you'll want to approach your tax planning with considerable care this year. That's because decisions you make now may help mitigate the effect of rate changes that are scheduled to take effect in 2013. Other changes may take place as well, depending on how Congress and the president decide to deal with the nation's fiscal challenges. High-net-worth individuals should therefore keep an eye on policy developments, bearing them in mind as they discuss tax planning options with their advisors.

Key considerations this tax season

When income tax rates hold steady, the standard approach is to accelerate deductions into the current tax year and defer income into the next year. However, when rates are scheduled to rise, as is the case for 2013 (barring Congressional action), you and your advisor should also consider taking the opposite approach. That's because accelerating income will allow you to take advantage of the lower tax rates in 2012, before they expire. Likewise, delaying deductions until tax rates rise in 2013 will help you offset your tax liability that year. This presumes that your income remains relatively stable from year to year and that tax rates will indeed go up once 2012 ends.

In 2013, the top marginal tax rate is scheduled to rise to 39.6%, at which time a 36% bracket will be created. Married couples who file jointly and have combined taxable income of approximately \$218,450 will enter the 36% tax bracket, as will unmarried individuals with income of roughly \$179,400. Income above an estimated \$390,050 (whether filed jointly or individually) will fall into the 39.6% bracket.

The scheduled rate increase results in part from the upcoming expiration of the 2001 and 2003 tax cuts. Another contributor is the federal healthcare act, which introduces a 3.8% Medicare tax on certain net investment income. For people in the highest tax bracket, the overall tax rate associated with interest, dividends, short-term capital gains, and passive income could rise to 43.4% in 2013, reflecting the combined effect of the 3.8% tax and the scheduled expiration of the current tax cuts. In fact, expiration of the tax cuts means that the favorable 15% tax rate for qualified dividends will go away so that all dividends will be taxed at ordinary income rates. Anticipating these changes as you consider your tax strategy will help you and your tax advisor devise a plan that generates the largest tax savings — both for this year and in the future.

It is important that you stay actively involved in your tax planning even after rate increases take effect. Doing so will help you ensure that the strategy your tax advisor pursues on your behalf adequately reflects and does not compromise

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

Income categories

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

- Ordinary income
- Portfolio income

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

Ordinary income

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

Outlook: Top tax rates for personal income

The following table depicts how tax rates will increase for high-income taxpayers from 2012 to 2013 if Congress does not intervene.

	Wages	Long-term capital gains	Qualified dividends	Passive income	Active income from general partnership	Active income from S corp
2012 highest tax bracket	35%	15%	15%	35%	35%	35%
Medicare/SE tax on earned income	1.45%	0%	0%	0%	2.9%	0%
2012 highest marginal tax rate	36.45%	15%	15%	35%	37.9%	35%
Expiration of tax cuts in 2013	4.6%	5%	24.6%	4.6%	4.6%	4.6%
2013 highest marginal tax rate	41.05%	20%	39.6%	39.6%	42.5%	39.6%
New Medicare/HI tax effective in 2013	0.9%	3.8%	3.8%	3.8%	0.9%	0%
2013 top rate	41.95%	23.8%	43.4%	43.4%	43.4%	39.6%
Increase from 2012 to 2013	5.5%	8.8%	28.4%	8.4%	5.5%	4.6%

Tax planning strategies

As noted, when rates are on the rise, the general strategy for mitigating the tax effect is to accelerate or shift income and defer deductions. We recommend that in pursuing this strategy, you consider when income is earned and understand when expenses are deductible. Since individuals are cash-basis taxpayers, income is earned in the year it is actually or constructively received, and expenses are deductible in the year payments are made.

If you are planning to accelerate a large amount of income into an earlier year to take advantage of lower tax rates, you should factor in the time value of money. In other words, determine whether your money is best spent on the tax liability that will be incurred in the earlier year or whether it would be better to pay the taxes at a later date and invest those dollars in the meantime (considering both your expected investment return and your expected tax rate in the future).

Wage earners' income

Generally speaking, accelerating and shifting income may be challenging for an individual wage earner. Such individuals might nonetheless want to consider generating additional ordinary income in a lower-tax-rate year by accelerating bonus payments and/or exercising nonqualified stock options, if either opportunity arises.

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

In addition to accelerating income where possible, consider making the maximum contribution to your 401(k) retirement plan, since 401(k) contributions lower your taxable income. Such contributions will allow you to defer taxable income until retirement years while saving for your future — a strategy worth pursuing regardless of tax rates.

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

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

Business owners' and self-employed individuals' income

Business owners or self-employed individuals have more flexibility in the timing of their compensation, as well as in when they pay their business expenses. Because income for cash-basis taxpayers is not taxed until it is received, self-employed individuals have an incentive to bill and collect before tax rates go up. Rising tax rates may also prompt individuals to defer expense payments until 2013, since doing so will enable expenses to offset future income, thus resulting in greater tax savings for the individual business owner.

- **Using business losses to offset your tax liability**
Taxpayers who are decision makers for their businesses may have influence over the timing of income and the deferral of expense payments. It is possible to use ordinary losses from business activities to offset income from other sources and thus reduce your overall tax burden — but only if complex passive-activity-loss rules don't apply. These rules provide that losses will be allowed in the current year only if the taxpayer is actively involved in the business. When devising this tax strategy, taxpayers should also consider whether self-employment tax applies to their situation.
- **Bonus depreciation: Additional tax deduction for business owners and landlords**
Special or “bonus” depreciation allows taxpayers to claim an additional deduction for certain tangible business property in the year the property was placed in service. Taxpayers can deduct 50% of the cost of certain items placed in service during 2012.

In 2013, bonus depreciation will no longer be allowed, unless Congress acts to extend this provision. To take advantage of the deduction while it's still available, individuals who are considering making capital improvements to business assets might consider accelerating into 2012 the date that such assets are placed in service, while also keeping in mind scheduled tax rate increases for 2013. Bonus depreciation is not phased out for high-income taxpayers or for those with large amounts of qualifying property. Generally the property must be new to qualify for bonus depreciation.

- **Offsetting ordinary income via SEP-IRAs and solo 401(k) plans**
Self-employed individuals can also take advantage of contributions to retirement plans. An individual with a simplified employee pension individual retirement account (SEP-IRA) may be eligible to make a contribution up to the lower of \$50,000 or 20% of net self-employment income after deducting self-employment tax. Making such a contribution will offset the ordinary income earned in 2012, 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 2012 individual tax return, including extensions (October 15, 2013 if your return is extended). This gives you significant flexibility in how you time your contribution, as well as allows you to determine the exact maximum contribution that can be made.

Alternatively, a self-employed individual can establish a solo 401(k) plan. Advantages that a 401(k) has over a SEP-IRA include the ability for the individual to take a loan from the plan, which is not allowed with IRA-type arrangements. The maximum total contribution that an individual is allowed to make to a solo 401(k) is the same that is allowed for a SEP-IRA (\$50,000); however, the percentage of income limitation on SEP-IRAs and solo 401(k) plans is calculated differently. Therefore, individuals earning less than \$200,000 in self-employment income may find that a solo 401(k) plan allows a higher contribution.

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

Retirees' income

A retired individual's overall tax planning should take into account the timing of distributions from retirement plans. Certain qualified retirement plans allow an individual to receive a lump-sum payment instead of staggered annual payments. The form of payment you choose should depend on your current and future income. It should also depend on whether the savings of paying income tax on a lump-sum payment now — at the lower rates currently in effect — outweigh 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 3.8% Medicare tax.

- **Roth IRA conversions**

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

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

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

Portfolio income

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

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

Intra-family loans

Another portfolio income planning strategy involves lending money to family members. If, for instance, a family member is seeking a mortgage, you may want to consider acting as the lender. Currently, the minimum rate that you would be required to charge the mortgage recipient, the applicable federal rate (AFR), is near an all-time low — lower than the interest rate a financial institution would charge for a conventional loan. The potential benefit for you, financially, is that the arrangement could very well generate a better rate of return than you'd obtain by keeping the money in a conventional investment. If the loan is secured by the residence, the borrower (i.e., your relative) might be able to deduct the interest. By obtaining a loan from you instead of through a financial institution, the borrower will pay considerably less interest expense in the long run.

Capital gains and losses

Congress extended the favorable long-term capital gains rate through 2012. Short-term capital gains realized on the sale of investments held for less than a year are taxed at the same tax rate as ordinary income. Barring legislative action, the maximum tax rate for ordinary income is due to increase from 35% to 39.6% at the beginning of 2013. The tax rate for long-term capital gains realized on the sale of investments that are held for longer than a year is scheduled to rise from 15% to 20% in 2013. It is important to remember, however, that in 2013 a special reduced long-term capital gains rate for five-year long-term gains is to be reinstated. If you purchased an asset after 2000 and have held the asset for more than five years, you may qualify for a reduced long-term capital gains rate of 18%. Careful planning will help you limit the impact that the increased tax rate will have on your capital gains.

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

Capital gains that are triggered during 2012 will be taxed at the current, lower tax rate. Capital losses triggered in 2012 will first be used to offset this year's capital gains, which are subject to the lower capital gains tax rate.

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.

Careful planning will help you limit the impact that the increased tax rate will have on your capital gains.

Therefore, you should employ a strategy that ensures that your carryover losses offset short-term capital gains when possible, regardless of whether those losses resulted from short-term or long-term transactions. If you have net capital losses overall in 2012, you may use up to \$3,000 of the capital loss to offset ordinary income, with the rest of the loss carried forward to offset capital gains in future years until it is fully diminished. Capital loss carryovers cannot be carried back to offset previously taxed capital gains.

As a result of stock market volatility, many taxpayers may find they have unused capital loss carryovers. Given the scheduled increase in tax rates, these capital loss carryovers should be viewed as an asset. If you still have a loss carryforward at the end of 2012, your previously generated losses will offset future capital gains when the tax rates increase, thus providing you with greater tax savings.

Before the tax year ends, you and your advisors should do a comprehensive review of your portfolio to determine what, if any, investments should be disposed of and whether it makes sense for you to sell those assets in 2012. For capital transactions that will produce capital gains, it might be best to proceed with those transactions before the end of 2012, whereas transactions that will result in a loss might best be deferred until offsetting gains are realized at the higher tax rates scheduled for 2013.

Commodities and collectibles

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

Upon being sold, such investments garner less-favorable tax treatment than other capital assets if the seller has possessed the items for a “long-term” holding period. Specifically, commodities and collectibles held as direct investments are taxed at a rate of 28% if they’ve been owned for longer than 12 months — this in contrast to the more-favorable long-term capital gains rate of 15% (which is scheduled to rise to 20% in 2013). If, on the other hand, the seller has owned the investment for a “short-term” holding period, the tax rate is the same as for any other type of investment (i.e., the gain on the sale of the investment is taxed at ordinary tax rates).

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

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

Capital gains tax

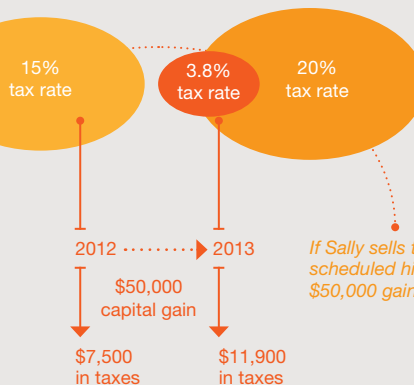
What one stockholder gains from triggering it in 2012

Sally holds a stock that has appreciated \$50,000 since she purchased it in 2010. She was planning to sell this investment in early 2013.

When Sally meets with her accountant, he points out that in 2013 the tax rate on long-term capital gains is scheduled to increase — rising from 15% to 20%.



Sally's accountant suggests that she consider taking advantage of the current lower tax rate by selling the stock in December 2012. By doing so, Sally would realize a \$50,000 capital gain, with a tax of \$7,500.



If Sally sells the stock in 2013, at the scheduled higher rates, her tax on a \$50,000 gain would be \$11,900.

In discussing Sally's options with her, the accountant points out that the alternative minimum tax (AMT) and the return of the 3% itemized deduction phase-out in 2013* do not apply to Sally's current set of circumstances.

The accountant notes that since Sally is in a high tax bracket, a 3.8% Medicare tax would also be imposed on the gain if she sells the stock in 2013.

* The effects of the alternative minimum tax and the 3% itemized deduction phase-out should be factored into an individual's overall tax picture and decision-making. These concepts are discussed in this chapter.

The timing of your itemized deductions should play a role in your overall income tax planning.

Deductions

Given that tax rates are scheduled to increase in 2013, taxpayers should consider deferring their deductions until then. By deferring deductions until 2013, you will create tax savings by having your deductions offset future income, which will be taxed at higher rates. However, taxpayers should keep a close eye on legislative initiatives aimed at limiting deductions for high-income taxpayers to 28%. If such legislation is passed, high-income taxpayers should consider accelerating income and deductions into 2012, which would allow them to benefit from their deductions and also take advantage of the lower income tax rates.

Personal-exemption phase-out and itemized-deduction haircuts

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

Under the Bush administration, the phase-outs were put into reverse. For years, they were gradually rolled back so that in 2010 no taxpayer of any income level lost any of his or her personal exemptions or itemized deductions. The Obama administration has extended this relief to all taxpayers through 2012. Beginning in 2013, however, the limitations on itemized deductions and personal exemptions for high-income taxpayers are scheduled to return to the original levels set during the Clinton administration.

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

Itemized deductions

The timing of your itemized deductions should play a role in your overall income tax planning. In the past, taxpayers have generally sought to accelerate year-end state income tax, real estate tax, and charitable contribution payments into the current year to obtain the maximum deduction for that particular year. This logic might bear rethinking this year, since rates are scheduled to increase in 2013. As state governments continue to face budgetary shortfalls and deficits, state income tax rates are on the rise. It is important that you consider the alternative minimum tax if you are planning to accelerate deductions such as real estate taxes, state tax payments, and miscellaneous itemized deductions. (The alternative minimum tax is discussed in greater detail later in this chapter.)

To wait, or not to wait

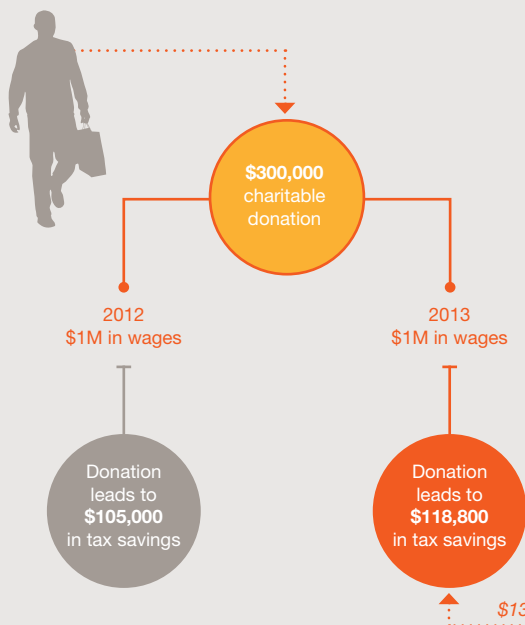
The benefits of delaying

Peter plans to donate \$300,000 in cash to his favorite charity. He is contemplating making the donation either this December or the following month.

His accountant notes that because federal tax rates are scheduled to rise at the start of the new year, Peter might want to make his contribution in January 2013 instead of December 2012. Doing so would increase Peter's tax savings.



Peter's accountant notes that Peter should obtain the required acknowledgment letter from the charity when making the donation.



Peter is projected to earn wages of \$1 million in both 2012 and 2013. His accountant crunches the numbers and determines that making the \$300,000 charitable donation in 2013 instead of 2012 would yield Peter additional tax savings of \$13,800.

In discussing Peter's options with him, the accountant points out that the alternative minimum tax (AMT) and the return of the 3% itemized deduction phase-out in 2013 do not impact Peter's results.*

* The effects of the alternative minimum tax and the 3% itemized deduction phase-out should be factored into an individual's overall tax picture and decision-making. These concepts are discussed in this chapter.

If you are in an overall loss position for the year after all your items of income and loss have been calculated, you may be entitled to a deduction for a net operating loss.

Charitable contribution planning should be done by year-end to ensure maximum deductibility and to determine if any charitable contributions should be deferred until 2013. To be deductible in the current year, your cash charitable contributions to public charities should not exceed 50% of your adjusted gross income. Similarly, if you plan to donate appreciated property to a public charity, the deduction cannot exceed 30% of your adjusted gross income. Any contributions that exceed these limits will be carried forward for up to five years. Gifting appreciated property is an excellent strategy to maximize deductions. It's important to speak with your tax advisor before making such donations to ensure that you have a valid deduction. (For more on tax considerations related to charitable contributions, please see this guide's chapter on charitable giving.)

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

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

Taxpayers who entered tax year 2012 with passive activity loss carryforwards should consider pursuing investment strategies that might produce passive ordinary income, since the loss carryforwards will potentially offset income that is taxed at the highest rates. Another tax planning option is to trigger the release of the suspended passive losses by disposing of the investment in the year of higher tax rates. The overall effect of these strategies is a decreased tax burden. However, these opportunities should be pursued only after you have carefully considered them in the context of your overall investment and business strategy.

Net operating losses: Carryback and carryforward options

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

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

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

Business deductions for owners and their companies

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

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

“Wash sale” rule

Bear in mind the “wash sale” rule that applies to the disposition of an asset when a loss is recognized. You won't be allowed to deduct the loss if you repurchase the same security during the 30-day period before or after the sale date. This rule ensures that you will not be able to reinvest in an identical position of the investment while recognizing the benefit of a loss on your original investment. Note, however, that currently there are no such provisions for a transaction in which a gain is recognized. Therefore, if you have an investment position that has appreciated significantly, you may sell the investment and realize the gain at the current lower tax rates, then immediately reinvest, with a higher cost basis.

Alternative minimum tax

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

One of the most significant adjustments in the AMT calculation is the disallowance of certain itemized deductions, including state and local income taxes and miscellaneous itemized deductions. Other items that must be adjusted for AMT purposes include tax-exempt interest on certain private-activity bonds; the bargain element of incentive stock options; and depreciation, which must be recalculated for AMT purposes over a longer recovery period. The maximum tax rate that can be applied to your AMT income is 28%. It is important to note that although the AMT rate is lower than the current and scheduled regular tax rates, this lower rate is applied to a higher taxable amount, often resulting in an increased overall tax liability. Long-term capital gains that are taxed at the lower 15% rate for regular tax purposes continue to be taxed at the same preferential rate under the AMT structure.

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

The key to AMT planning is finding the breakeven point where your regular tax liability and your AMT liability are equal.

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

The AMT patch provides an increased AMT exemption for taxpayers. The most recent patch did not extend beyond 2011. As of this writing, it remains to be seen whether Congress will extend the patch to tax year 2012.

Some of the tax proposals, including those in President Obama’s budget for fiscal year 2013, could have a significant impact on the AMT. Absent any large-scale AMT tax reform, many upper middleclass taxpayers are likely to fall under the AMT tax regime. However, for some taxpayers, the scheduled increase in regular income tax rates reduces the likelihood of their paying the AMT.

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

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

Kiddie tax

Income-shifting generally involves transferring income-producing property from high-income taxpayers to someone who is taxed at a lower rate. For high-income individuals, shifting income to children or other family members who are in lower tax brackets generally proves an effective long-term planning strategy. Bear in mind, however, that children under age 18 and fulltime students under age 24 will be taxed at the parent’s higher income tax rate on investment income that exceeds a threshold amount (for 2012 this amount is \$1,900, potentially preventing the shifting of such income to children from resulting in any tax savings).

Household employment taxes

Many households hire individuals to do various kinds of work. However, the personal tax effects and filing requirements of hiring household employees are often overlooked. Determining whether, from a tax perspective, these individuals are considered employees or independent contractors depends on the type of services they render and the control that you, as the employer, have over how they perform those services. If you pay a household employee more than the annual limit of cash wages (for

2012 this amount is \$1,800), you will be liable for Social Security and Medicare taxes for that individual. Those tax payments are remitted when you file your individual income tax return and may need to be factored into your quarterly estimated tax payments if you are to avoid underpayment penalties.

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

Reporting income from foreign investments

Many US investors include foreign direct investments in their overall investment portfolio. These investments are permitted under US tax law but require additional reporting and compliance. It is important, therefore, that you factor this requirement into your tax planning activities.

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

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

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

Conclusion

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

A photograph of a woman and a young girl sitting at a desk, looking at a laptop. The woman is on the left, smiling, and has her hand on the girl's shoulder. The girl is on the right, also smiling, and is looking at the laptop screen. The woman is wearing a purple long-sleeved shirt and a gold earring. The girl is wearing a brown long-sleeved shirt with a heart design. The laptop is silver and is open on the desk. In the background, there is a white shelf with some papers and a person wearing a blue and white striped shirt.

*Managing
your
investments*



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

Managing your personal investments and planning for your family's ongoing financial security can be challenging in the best of conditions. Today, there's the additional challenge of accomplishing those tasks against the backdrop of a slow-growing economy and still-volatile market — both of which are affected by developments around the world. In this atmosphere of prevailing uncertainty and global economic interdependency, it's important to have an investment strategy that will keep you on an even keel while also letting you remain flexible enough to capitalize on new opportunities when and where they arise.

Building your investment plan

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

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

Assemble your investment advisory team

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

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

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

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

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

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

Determine your goals and constraints

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

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

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

Great expectations

Investing in your child's future

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

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



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



Assuming an inflation rate of 5% and a nominal return on investment of 6.5%, Jeremy and Nicole would have to contribute \$884 per month over the next 18 years to fully fund Emily's college tuition.

Emily goes to college with her projected four-year tuition fully funded in the amount of \$363,049.



Current annual cost	\$35,000
Annual inflation rate	5.0%
Number of years until first year of college	18
Number of years in college	4
Nominal return on investment	6.5%
Projected college cost	\$363,049
Monthly contribution needed to fund cost	\$884

Risk really comes down to one factor — how much of your portfolio you are willing to put at risk of loss in order to achieve a desired rate of return.

Investment policy statement

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

Assess the risk/return tradeoff

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

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

Required risk

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

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

Risk capacity

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

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

Asset allocation lays out a roadmap that will keep you from chasing returns or overreacting to unexpected market conditions.

One common method of measuring risk capacity is the Monte Carlo analysis. This analysis runs a set of assumptions through multiple simulations using random variables, such as rate of return, to measure the probable success or outcome. Commonly, the Monte Carlo analysis is used to test assumptions in all types of hypothetical market conditions and based on all types of returns. Theoretically, the higher the success rate, the more likely you are to achieve your stated investment goals, regardless of the market environment going forward. If you have excess risk capacity, creating a more conservative investment portfolio — and thereby reducing the risk — could improve the success rate in a Monte Carlo analysis. Your wealth management team will know how to run the appropriate simulations and draw reasonable conclusions.

Risk tolerance

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

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

Allocate your assets wisely

Asset allocation is the underlying principle of modern portfolio theory. It lays out a roadmap that will keep you from chasing returns or overreacting to unexpected market conditions. But as everyone knows, a roadmap won't alert you to details such as traffic conditions, detours, or a closed exit ramp — an important limitation to consider when applying this metaphor to your investment strategy, as well as a key reason for assembling a solid investment management team. Studies have consistently shown that trying to pick the right entry and exit points in the market rarely, if ever, work. The same holds true of investment fads. A vigilant investment team can help you avoid these wrong turns by recommending changes to your portfolio that are tactical and strategic, rather than changes that are reactive or based on guesswork about market timing.

Asset-class selection

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

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

Asset allocation as diversification

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

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

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

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

Strategic and tactical allocation

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

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

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

Global diversification

Investing internationally

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

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

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

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



Your investment opportunities can cross borders

Commonly used means of international investment

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

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

Common risks

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

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

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

It can be tempting to put brokers and investment advisors in competition with one another as they seek accounts that provide the highest return. This approach often leads to inefficiencies.

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

When determining the correct asset allocation in the context of meeting goals such as retirement objectives, don't forget to incorporate the basic rules of personal liquidity risk management: Have a liquid cash reserve available to pay living expenses in the event of a personal crisis or a down market. Advisors differ on how large a cash reserve you should maintain. Generally, however, it is considered prudent to have enough cash on hand to cover one to three years' living expenses, depending on your circumstances.

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

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

Review your portfolio's performance

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

Rebalancing your portfolio

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

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

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

Fees and expenses

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

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

- **12b-1 fees:** These fees are applied toward fund advertising and marketing, primarily to compensate fee-based advisors who provide services for the fund's shareholders. These fees can range from zero to .75% of the assets' value.
- **Annual account fee:** This is sometimes charged by brokerage houses to cover required IRS reporting and filing costs.
- **Investment management fee:** This fee is charged by an investment advisor who is overseeing a personal portfolio. It is commonly charged as a percentage of assets or as an hourly rate by fee-only planners.
- **Other expenses:** These include indirect costs such as those associated with accounting, administration, recordkeeping, and legal work, as well as fees for separately managed funds.
- **Management fees:** These are part of a fund's annual operating expenses and are used to compensate the fund manager.
- **Frontload fee:** This is a commission charged up front when you invest in a mutual fund. It is in addition to the fund's ongoing operating costs. For example, a mutual fund may charge you a 5% frontload fee for investing in the fund. If

you invest \$10,000, then \$500 will be taken out of the investment up front, and the remaining \$9,500 will be invested in the fund. This fund will have to generate a higher rate of return if it is to equal the return you receive from a no-load fund, assuming that all other fees are equal.

- **Deferred-load fee:** In contrast to a frontload fee, a deferred-load or redemption fee applies to certain funds if you sell them within a stated time frame. Such fees are often meant to discourage short-term investing in a fund.
- **Transaction costs:** These are the costs associated with buying and selling securities, either within a fund or directly. They are what a brokerage house charges to trade a bond or security and typically range from \$5 to \$50 but may be higher than that.

Achieving tax efficiencies through strategic asset location

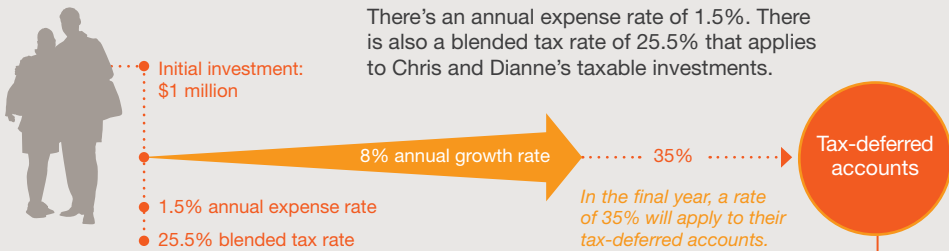
Up to this point we have not said much about the impact of income taxes on investment decisions. Make no mistake: Income taxes matter in the investment process. With tax rates scheduled to rise (barring Congressional action), income taxes may soon matter even more.

As of this writing, tax reductions enacted in 2001 and 2003, and then extended in 2010, are scheduled to expire at the end of 2012. In addition, there is always the potential that proposed legislation aimed at increasing income tax rates and limiting deductions for individuals will become new tax law. It's important, therefore, that your asset location decisions take into account the impact that current and potential future income taxes will have on your portfolio return. One way to mitigate the effect that income tax has on your portfolio is by achieving tax efficiencies via strategic asset location.

Weighing alternative investment scenarios

How different strategies play out over time

Chris and Dianne make an initial portfolio investment of \$1 million, which grows at a rate of 8% annually.



Chris and Dianne are contemplating three alternative actions:

- 1 Lowering the annual expense rate to .5%
- 2 Moving to a state with no tax rate
- 3 Changing the location of their investments

Each of these scenarios could have a significant impact on the overall return of Chris and Dianne's portfolio over time.*

This third scenario would better enable Chris and Dianne to use qualified rates on capital gains, tax-free investments, and tax-deferred accounts to obtain a blended rate of 11% annually and 35% in the final year for their retirement accounts.

Year	Current situation	Lower fee	No state taxes	Asset relocation
0	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
5	\$1,242,779	\$1,284,177	\$1,264,120	\$1,286,021
10	\$1,547,857	\$1,653,754	\$1,601,177	\$1,661,533
25	\$3,022,949	\$3,580,631	\$3,284,264	\$3,654,228
50	\$9,498,480	\$13,470,079	\$11,124,320	\$14,094,989

* This example ignores the impact of inflation.

Asset location decisions are often very complicated and must take into account many variables besides income taxes.

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

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

Which investments to own inside these accounts depends on the investment purpose of a given bucket. For example, taxable bonds generate interest income that is taxed at ordinary income tax rates and, for that reason, are often held in tax-deferred accounts.

Stocks also generate capital appreciation that could be taxed at ordinary income rates (if held less than one year) or at favorable tax rates if held longer than one year. For this reason, stocks have generally been held in taxable accounts. Of course, if the investment holding period is very long, owning stocks inside tax-deferred accounts may make more sense, because their potentially higher returns could make up for the ordinary income tax rate upon distribution.

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

Investor behavior

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

Generally speaking, investor behavior tends to mirror the current state of the economy and the business cycle: If things are looking good, investors tend to be positive; if things start to take a turn for the worse, their attitudes turn negative. Most investors focus on the present (present job situation, current economy, recent stock movements, and so on), making investment decisions that can be nearsighted and counterproductive.

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

Conclusion

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

A group of young women are running a race on a grassy field. They are wearing yellow and white t-shirts. The woman in the foreground on the right is wearing a white t-shirt with a race bib number 498 and is pointing upwards with a smile. The woman in the middle is wearing a yellow t-shirt with a logo that says "Run For Help" and a shoe icon. The woman on the left is wearing a yellow t-shirt with a race bib number 16. There are many colorful balloons (yellow, pink, red) in the background. The text "Charitable giving" is overlaid in orange script on the right side of the image.

Charitable giving



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

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

***Special considerations:
Potential tax law changes***

Potential changes are afoot where tax deductions for charitable giving are concerned. Periodically tax law proposals contain provisions that aim to limit the value of certain itemized tax deductions, including those for charitable contributions.

Proposals to limit deductions for charitable contributions are controversial. The most recent of these proposals has met with opposition from some members of Congress, who view limitations on deductions for charitable contributions as an inappropriate means of increasing government revenue. Nonprofit organizations have also raised objections, fearing that such limitations would lead to a reduction in donations.

Generally, gifts of cash to public charities are fully deductible up to 50% of a donor's adjusted gross income.

In times of tax law uncertainty, we recommend that you meet with your wealth management advisors to review your charitable-giving strategies, particularly around the timing of charitable contributions, given the potential tax-deduction cap that might apply to future giving.

Charitable structures

There are a number of commonly used charitable structures. Each carries different tax considerations. It is important, therefore, that you not only align your charitable goals with the structure that best supports them, but also adequately contemplate the accompanying tax implications.

Public charities

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

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

Community foundations

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

Donor-advised funds

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

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

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

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

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

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

Private foundations

A private foundation is a tax-exempt organization created exclusively for religious, charitable, scientific, literary, or educational purposes. However, the degree to which it relies on volunteers and public donations isn't sufficient to qualify the foundation as a public charity. Unlike public charities, private foundations generally pay a 1% or 2% excise tax on their net investment income, including capital gains.

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

Gifts of cash to private nonoperating foundations are fully deductible up to 30% of a donor's adjusted gross income. Gifts of appreciated securities to nonoperating foundations are generally deductible up to 20% of a donor's adjusted gross income. A key benefit of a private operating foundation is that gifts to it are subject to the same AGI limitations as gifts to public charities. Regardless of whether the foundation is categorized as operating or nonoperating, any gift in excess of the AGI thresholds will be subject to a five-year carryforward period (i.e., the excess amounts will be carried forward and be deductible for up to five years following the year of the gift).

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

Supporting organizations

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

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

Donation methods

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

Deferred gifts

Not all donors choose to make charitable gifts that take effect right away. Rather, some donors prefer to make charitable donations that will take effect in the future. Gifts that will benefit a charitable organization at a later date are often referred to as deferred gifts.

The most typical deferred gift involves a transfer in exchange for a retained benefit or a lifetime benefit. Deferred gifts to charities can consist of annuity-type arrangements, remainder interests in certain types of property, and various types of charitable remainder trusts. These options can give donors great flexibility in meeting their goals.

Gift annuity

The charitable gift annuity is among the most popular forms of deferred charitable gifts. One simple approach to this type of giving is for the donor to transfer cash, securities, or, in some cases, real estate to an established charity in exchange for the charity's promise to pay an annuity to the donor and/or other named beneficiaries. The value of the charitable contribution is the difference between the annuity value and the value of the property transferred. In addition, a portion of each annuity payment is treated as a return of capital and is not taxed as income over the person's life expectancy, as determined based on actuarial tables.

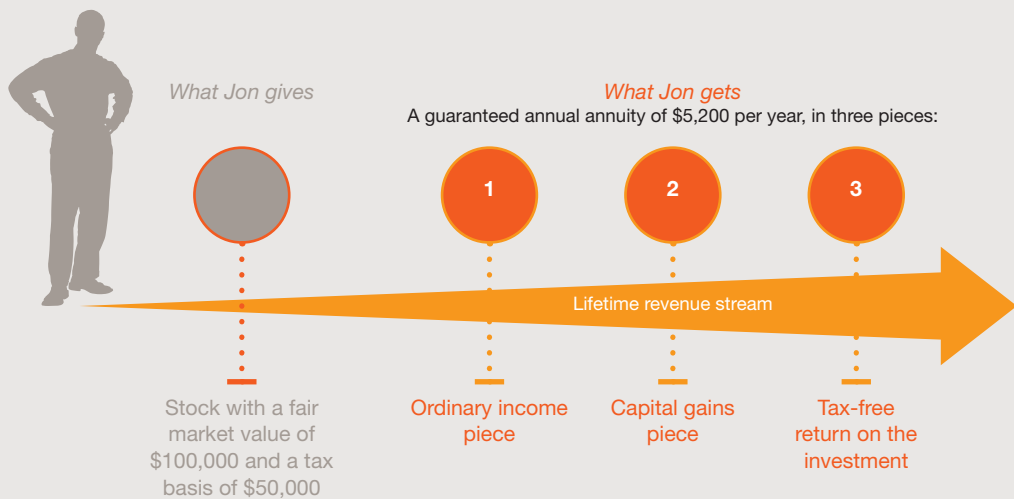
Remainder interest in a personal residence

A popular method of mitigating estate tax on a personal residence (i.e., a residence that is not your primary residence but is, say, a vacation home or a farm) while gaining a lifetime income tax charitable deduction is to give a remainder interest in that property to charity. The income tax charitable deduction is based on the present value of the charity's remainder interest. Although the personal residence would be included in the individual's estate, an offsetting charitable deduction would be available for estate tax purposes.

Gift annuity: Two birds, one stone

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

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



Conservation easement

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

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

Charitable remainder trust

The charitable remainder trust (CRT) is a popular vehicle for deferred giving, one that offers various structures to match the needs of donors. The transfer is accomplished by creating a trust that pays income to individuals during the trust's existence, with the remainder in trust going to charity. The year the CRT is funded, the donor is allowed to make a charitable deduction equal to the remainder interest passing to the charity when the trust's term ends.

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

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

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

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

Charitable remainder trust

How supporting the arts can double as a sound personal investment

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



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

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

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

Charitable lead trust

A charitable lead trust (CLT) provides a charity with income for a set period, with the remainder going to a family member or noncharitable beneficiary. 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 entitled to an income tax charitable deduction if the charitable interest is in the form of a fixed percentage of trust assets or a guaranteed annuity and if the donor will be taxed on the trust's annual income as it is earned (i.e., a grantor trust). If the donor establishes a nongrantor CLT, the donor will not receive a charitable income tax deduction, nor will he or she be taxed on the trust's income each year.

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

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

Postmortem planning through charitable strategies

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

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

Whether charitable planning makes sense for your wealth management strategy

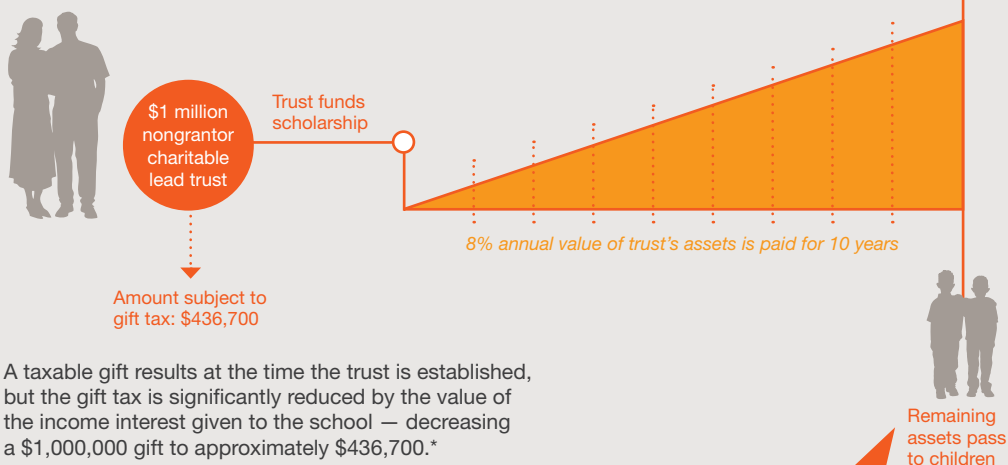
Many charitable-giving strategies include arrangements that require the donor to relinquish control of the donated assets. If moving your family's assets outside your control makes you uncomfortable, charitable giving might not be the best fit for your overall wealth management plan.

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

Charitable lead trust

Investing in future generations

Andrew and Rachel place appreciated securities with a value of \$1,000,000 into a nongrantor charitable lead unitrust. The trust is to pay income for the funding of a scholarship at the private school their children attended. The payout is set at 8% of the annual value of the trust's assets for a term of 10 years. At the end of 10 years, the remaining assets will pass to Andrew and Rachel's children.



A taxable gift results at the time the trust is established, but the gift tax is significantly reduced by the value of the income interest given to the school — decreasing a \$1,000,000 gift to approximately \$436,700.*

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

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

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

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

** The GST exemption is \$5,120,000 until the end of 2012, at which time it will fall to \$1,390,000, barring Congressional action. Taxpayers considering transfers to grandchildren should consult their tax advisor before the end of 2012.

Charitable strategy overview: Pros and cons

Donor-advised fund

Advantages

- Grants the donor a current charitable deduction for the value of the property transferred to the fund
- Subjects donations to the same AGI limits as public charities
- Generally charges low setup and annual maintenance costs
- Provides the donor with administrative support related to its charitable giving
- Does not subject the donor to annual IRS reporting requirement

Disadvantages

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

Private foundation

Advantages

- Grants the donor a current charitable deduction for cash and the value of appreciated securities transferred to the foundation
- Provides control over grant recipients
- Allows for control over investment management
- Provides for intergenerational transfer of control
- Allows donors to address an underserved need not already met by a public charity
- Provides senior members of the family with an educational tool for schooling the next generation in wealth management

Disadvantages

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

Gift annuity

Advantages

- Grants the donor a current charitable deduction
- Reduces the donor's taxable estate
- Provides the donor with a current income stream
- Provides the charity with current assets
- Requires less tax-compliance effort on the donor's part than do charitable remainder or lead trusts

Disadvantages

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

Remainder interest in a personal residence

Advantages

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

Disadvantages

- Donated property passes to charity instead of heirs
- The charity must wait to receive the real estate
- Exclusion of gain on sale of primary residence may be lost

Conservation easement

Advantages

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

Disadvantages

- Donated property passes to charity instead of heirs

Charitable remainder trust

Advantages

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

Disadvantages

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

Charitable lead trust

Advantages

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

Disadvantages

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

Misconceptions

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

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

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

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

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

International charitable giving

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

Generally, contributions by an individual to a non-US charity are not deductible for US income tax purposes. That's because US tax rules specify that qualifying charitable entities must be organized under US laws. There are exceptions, however. For example, certain tax treaties between the United States and other countries allow a taxpayer to deduct charitable donations made to organizations created in specified countries. Meanwhile, 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 (sometimes referred to as "friends of" charities)
- US charities that operate foreign branches
- Domestic private foundations that direct distributions to foreign charities
- Donor-advised funds that direct distributions to foreign charities

There are various rules impacting deductibility of international donations made by US individuals to US charities, foundations, or funds. 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 case of domestic private foundations and donor-advised funds, the organizations must (1) ensure that when donations are made to a charity abroad, the foreign entity is considered equivalent to a US charity and (2) oversee the foreign charity's usage of the funds. US individuals should consider such rules before making donations to any organization that is operating abroad.

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

Conclusion

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

*Estate
and gift
planning*





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

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

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

Current status of estate and gift tax rules for 2012 transfers

Tax implications are an important consideration in the development of any estate plan. The estate tax has undergone numerous changes over the years, and current rules are due to expire at the end of 2012.

After expiring briefly in 2010, the estate tax and the generation-skipping transfer tax (GST) were retroactively reinstated on December 17, 2010 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Special rules applied to the estates of individuals dying after December 31, 2009 and before January 1, 2011. For gifts made after December 31, 2010, the gift tax is reunified with the estate tax and GST tax. This has the effect of increasing the lifetime gift, estate, and GST tax exemption to \$5,120,000 in 2012, and also results in a top tax rate of 35%. To the extent that the exemption is not used during an individual's life, it will be available to the person's estate upon his or her death.

For the estates of individuals who died in 2010, the executor was permitted to opt out of applying the estate tax rules. Opting out, however, meant forfeiting the date-of-death step-up in tax basis* and applying the modified carryover basis rules instead. Generally speaking, the modified carryover basis rules allowed for only a \$1.3 million step-up in basis (\$4.3 million if property was left to a surviving spouse), in addition to allowing the estate to forgo paying estate tax. It should be noted that the estate tax rule regarding carryover basis varies from state to state. A state's rule — which may be different from the federal rule — needs to be considered in determining the correct income tax basis of assets inherited by each beneficiary for state income tax purposes.

The 2010 legislation included a new provision that allows portability of the federal estate tax exemptions between spouses. As a result, the executor of a deceased spouse's estate is permitted to transfer any unused estate

tax exemption to the surviving spouse. The transferred exemption may be used by the surviving spouse for lifetime gifts or for transfers upon his or her death. Some limitations apply to the application of the portability rules. More importantly, portability does not apply to the GST exemption, nor has any state adopted the portability provision. The deduction for estate taxes paid to any state or to the District of Columbia was also reinstated for estates of individuals dying after 2009.

Rules for transfers after 2012

In 2013, estate, gift, and generation-skipping tax laws and rates are scheduled to return to their pre-2001 levels, barring legislative action in the meantime. This means that for the estates of individuals dying in 2013 or later, the maximum federal estate tax rate will return to 55%, with an estate tax exemption of \$1 million.

Also, for gifts made in 2013 and after, the maximum federal gift tax will be tied to the 55% estate tax rate, and the gift tax exemption amount will revert to \$1 million.

The 2013 GST tax rate is also 55%, and the GST exemption is \$1 million, indexed for inflation from 1998, which as of 2013 would be \$1,390,000.

The table at the top of the next page illustrates the estate and gift tax rates and exemptions that are in effect for 2012. It also shows the rates and exemptions applicable for 2013 under current law, although many observers expect Congress will enact more-favorable rates and exemptions for 2013 and future years.

* Most people believe that when they inherit property, they can immediately sell it without recognizing a gain. Generally their assumption is correct, because the tax basis is adjusted to what the property's value was on the date of death. This adjustment is called the "date-of-death step-up."

	2012	2013
Highest estate/gift tax rate	35%	55%
Estate tax exemption	\$5,120,000	\$1,000,000
Gift tax exemption	\$5,120,000	\$1,000,000
GST exemption	\$5,120,000	\$1,390,000*

*The GST exemption is indexed for inflation.

When is an estate plan appropriate?

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

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

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

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

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

Estate planning: Four main steps

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

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

Step 1: Assess the current situation

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

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

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

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

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

- Maintaining your current standard of living and planning for your future standard of living
- Providing for your surviving spouse and dependents
- Naming guardians for your minor children
- Designating someone to make financial and healthcare decisions in the event that you or your spouse becomes incapacitated
- Maintaining control over your assets during your lifetime
- Ensuring that your property is distributed according to your wishes — e.g., specifying who receives your property, the amount the recipient receives, the form in which he or she receives it (outright or held in trust), and who will manage your property for your heirs
- Making sure your property is transferred in an efficient, quick, and orderly manner
- Reducing the overall estate and gift tax liabilities — e.g., reducing the assets that are subject to tax, deferring the payment of tax, and taking maximum advantage of available exclusions, exemptions, deductions, and credits
- Preserving the value of your business and planning for ownership and management succession

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

If you do not have a will, the law of your state of residence will generally determine who receives your property.

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

Step 2: Determine planning options

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

Draw up a will

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

Sign “durable power of attorney” and healthcare proxy forms

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

Designate an executor and trustee

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

Bear in mind that recipients of payouts from life insurance policies and retirement plans are not specified by your will.

Review property ownership and beneficiary designations

For couples, part of the estate planning process involves evaluating whether you and your spouse (or partner) each have enough property in your separate names to take full advantage of the estate, gift, and generation-skipping transfer tax exemptions, exclusions, and credits that are in effect at any particular time. A review of asset ownership can help you determine whether lifetime gifts or transfers between you and your spouse or partner should occur to ensure that you each have enough assets in your own names to take full advantage of your available tax exemptions. In limited situations and for a limited time (only until the end of 2012, unless extended by legislation), portability may also allow you to take full advantage of both spouses' exemptions. Failure to plan properly in this vein can significantly increase your overall tax liability.

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

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

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

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

Consider the form and amount of property left to your spouse

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

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

An important part of estate planning involves determining which of these three options is best suited to meet your goals. Recognize that these options are not mutually exclusive; the total property passing to the surviving spouse may be divided, with different methods potentially used for each part of the transfer.

Outright transfers to a surviving spouse qualify for the marital deduction. However, such transfers may give rise to concerns regarding control over the property’s ultimate disposition and financial management. If the marital transfer is made by outright bequest, the spouse who dies first will have no control over the ultimate disposition of the property. This concern may be particularly relevant if either spouse has children from a previous marriage or if the surviving spouse remarries. Additionally, the surviving spouse may lack experience — or have little interest — in the financial management of property. Discussing this potential responsibility with your spouse before making a decision is therefore advisable.

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

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

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

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

Over time, an annual giving program can remove hundreds of thousands of dollars from your estate on a tax-free basis.

Use the estate tax exemption

Spouses are each entitled to an estate tax exemption of \$5,120,000 for 2012, which can be used after their deaths to protect that amount from estate tax. As discussed earlier, if you leave all of your property to your spouse, there will be no estate tax (due to the marital deduction). For 2011 and 2012 decedents, the surviving spouse may be allowed to use any unused estate tax exemption. When the surviving spouse dies and the combined property then passes to other beneficiaries, the unused estate tax exemption of the first spouse will be portable, meaning that it can be added to the second spouse's exemption to offset the estate tax.

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

There are, however, various other ways to use the estate and gift tax exemption to significantly reduce the overall estate tax: outright transfers to beneficiaries other than a spouse or charity, transfers to trusts that benefit both the spouse and other beneficiaries, and the potential use of disclaimers by the surviving spouse, to name several methods.

Give lifetime gifts

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

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

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

In addition to the \$13,000 annual exclusion, there is an unlimited gift and GST tax exclusion for any tuition paid directly to a school or for medical care payments made directly to a healthcare provider on someone else's behalf. Not only are these tuition and medical payments free of gift tax, but they also do not count against the annual gift tax exclusion. Tuition payments (but not room and board, books, or other expenses) made directly to a private elementary school, secondary school, or college generally qualify for this exclusion.

Gifts to a qualified tuition program, or 529 plan, do not qualify for the unlimited tuition gift tax break. However, there is a special rule allowing a contribution that is made to such a program or plan in a single year to be spread over five years. If done properly, this technique enables you to use five years of annual gift tax exclusions for a gift made in one year. For example, in 2012, an individual could transfer up to \$65,000 to a 529 plan and elect to treat the contribution as having been made ratably over five years.

Give now, in 2012, to save down the line

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



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



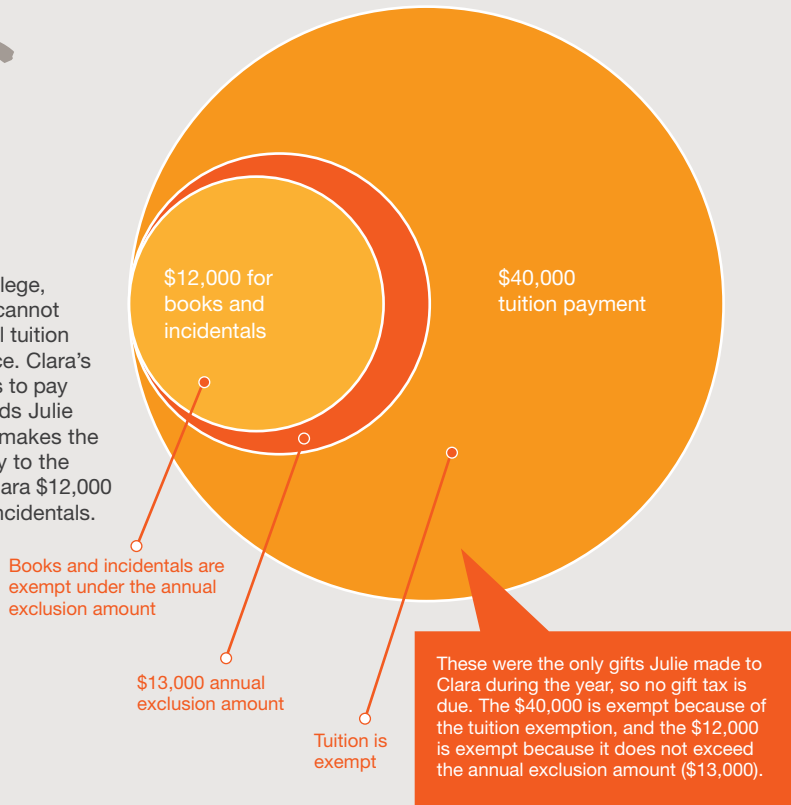
If Monica had instead decided to bequeath the money through her will, she would have run the risk of her family ultimately (1) dealing with a lower estate tax exemption and (2) paying tax on any value above the exemption, as well as tax on the appreciation of the \$3 million.

Monica consequently eliminates about \$3 million of future appreciation from her estate and locks in the current gift tax exemption amount, which is scheduled to expire at the end of 2012.

A nontaxing way to play fairy godmother: Paying for college



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



In 2012 there is also a \$5,120,000 gift tax exemption; the first \$5,120,000 of cumulative lifetime gifts is exempt from gift tax. The gift tax exemption amount used during a lifetime is subtracted from the estate tax exemption amount available upon death. However, even though the exemption may continue to be available upon death, you may nonetheless want to make gifts up to the \$5,120,000 exemption in your lifetime to eliminate future appreciation from your estate. Not doing so could translate into a lost opportunity if the \$5,120,000 exemption expires after 2012 and isn't reinstated by Congress.

Consider trusts and family entities

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

Life insurance trust

When the proceeds from a life insurance policy that you've taken out on your life are distributed to your beneficiaries, those proceeds are subject to estate tax. One way to protect them from estate tax is to transfer the policy into an irrevocable trust created for the purpose of holding the policy and managing or distributing the death benefit proceeds. A life insurance trust may also help address the liquidity needs of your estate. There are various options regarding the terms and beneficiaries of this type of trust.

Note that a life insurance policy that is transferred to an irrevocable trust will not be officially removed from your estate until three years after the date of transfer. For a new policy, you should consider having the trust acquire the policy directly rather than receiving it from you or someone else. This may allow the death benefit proceeds to escape estate taxation immediately, rather than three years later.

Grantor retained annuity trust

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

A GRAT allows you to retain the right to receive for a specified term of years an annuity stream that is equal to (1) the fair market value of the property at the time you create the trust plus (2) a fixed rate of interest. The fixed return over the entire annuity term is based on the prevailing interest rate (as published by the IRS) for the month the GRAT is created. If the trust assets produce an actual economic rate of return that exceeds the fixed return, the GRAT's beneficiaries will receive the excess either in trust or outright, and at little or no gift tax cost. While the assets are in the trust, you will remain responsible for the income tax liability on the income earned by the trust. The payment of the income tax liability provides an income tax benefit for the beneficiaries of the trust, since the tax payments are not considered gifts to the trust or the beneficiaries.

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

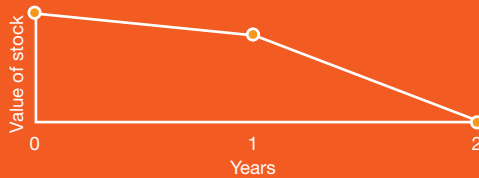
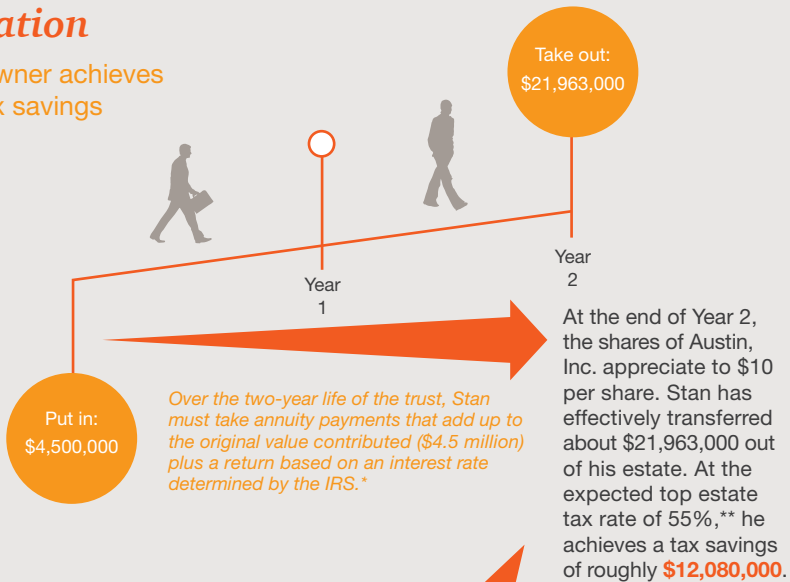
GRATs also work best when interest rates are low, because appreciation in the assets above the benchmark rate of return (the interest rate published by the IRS for the month the trust is created) passes to the beneficiaries. The lower the benchmark rate of return, the more the beneficiaries will receive.

GRAT gratification

How one business owner achieves substantial estate tax savings



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



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

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

** Scheduled to take effect at the start of 2013, barring Congressional action.

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

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

Qualified personal residence trust

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

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

Intentionally defective irrevocable trust

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

An IDIT is considered the same as the grantor for income tax purposes. Typically, there are two basic types of IDIT transactions: gifts and sales. For the gift transaction, the way the trust is drafted would cause any gifts to the trust to be treated as completed gifts (i.e., “true” gifts) for estate and gift tax purposes but not for income tax purposes.

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

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

If the trust assets produce an actual economic rate of return that exceeds the specified interest rates, the IDIT’s beneficiaries will receive the excess either in trust or outright, at little or no gift tax cost. Unlike GRATs, IDITs can also be used effectively as a tax planning tool vis-à-vis the generation-skipping transfer tax.

A dynasty trust allows you to set aside assets for your grandchildren and future descendants.

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

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

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

Dynasty trust

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

on the same transfer. It is designed to ensure that a tax is collected on the transfer of wealth from one generation to the next. As noted earlier, the GST exemption for 2012 is \$5,120,000. A dynasty trust helps you take full advantage of your GST exemption and is typically set up to last for as long as is allowed by the state law governing the trust.

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

Charitable trust

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

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

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

Family limited partnerships

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

One popular reason for forming a family partnership is to facilitate the transfer of wealth. That's because making gifts of partnership units to children, grandchildren, or trusts for their benefit allows the passage of family wealth without losing any of the sophisticated investment attributes available to large investment pools. Generally, property is contributed to a family partnership in exchange for both general and limited partnership units.

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

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

There is also a level of asset protection associated with family partnerships. The partnership unit ownership can be restricted to family membership or to trusts for family members. In addition, family partnerships offer protection of assets from creditors. Finally, family partnerships enable family members to invest through a single vehicle, which can reduce investment costs, facilitate recordkeeping, and provide flexibility that might not be available in a trust arrangement.

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

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

Cross-border considerations



Transfer tax treaties

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

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

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

Foreign-based property

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

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

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

As in the United States, adverse outcomes can sometimes be avoided or mitigated in foreign jurisdictions by using trusts and entities such as corporations and partnerships as substitutes for direct ownership of property. However, because

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

Matrimonial property

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

US wealth transfer taxes — Applicability to noncitizens

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

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

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

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

Step 3: Implement the estate plan

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

Implementation also involves producing an estate tax balance sheet that reflects the changes made and then revising the estate flowchart to illustrate how the estate will pass according to the new plan.* The flowchart would, as described earlier in this chapter, include the estimated estate tax due under the new plan and a liquidity analysis to determine how the tax and other expenses will be paid.

Step 4: Monitor the plan

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

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

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

Conclusion

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

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

Business succession





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

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

Passing the baton... with due foresight

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

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

* Forty percent of US respondents in PwC's Global Family Business Survey said they do not have a succession plan (*Family Business Survey 2010/2011 — A US Perspective*).

Lack of an official plan can lead to a host of problems when the current owner ceases to maintain control. For instance, it may turn out that the next generation is reluctant, unprepared, or unable to take the reins (or, in some cases, the family line may end with the current owner's generation). Alternatively, the owner might identify a willing successor but find that family members and other key stakeholders do not support the decision. The business owner could also discover that keeping things in the family simply isn't feasible (i.e., there isn't enough liquidity to support a family buyout from the previous generation). Although such issues can be difficult to confront — and therefore tempting to put off — it is better to deal with them now rather than at the last minute, when options may be limited.

Paving the path forward: Main steps

There are certain basic but critical steps that should be taken to help ensure the successful transfer of a business. Too often, however, such steps are skipped or insufficiently executed, hindering a smooth leadership transition. Lacking these, an informal succession plan may be of limited use when it's time to put the plan in action. Succession planning done right, on the other hand, entails going through the following paces:

- **Start early:** Early planning will help a business owner determine whether passing the business on to the next generation is in fact feasible. If keeping the business in the family is a realizable goal, the owner should allow ample time for choosing a successor, grooming that individual, delegating other leadership responsibilities, and determining equitable

compensation among family members — all of which a well-designed succession plan is meant to do. If it turns out that keeping the business in the family is not desirable or feasible, the owner will need to have a well-considered Plan B in place (e.g., sale to other shareholders or a third party).

- **Identify a successor:** To provide an adequate level of certainty that the business will survive beyond its current ownership, the individual(s) at the helm must decide who will be given the opportunity to run the business down the line — whether it be another family member, other shareholders, key employees, or a third party, such as an executive hired from outside the business. This last option is one that a business might take if family members are not interested in leading the company (e.g., because they are already well established in satisfying careers elsewhere) or lack the right qualifications. In some cases, an outside executive may serve an interim role, functioning as a “bridge” until younger, interested members of the family are ready to take on senior management roles.

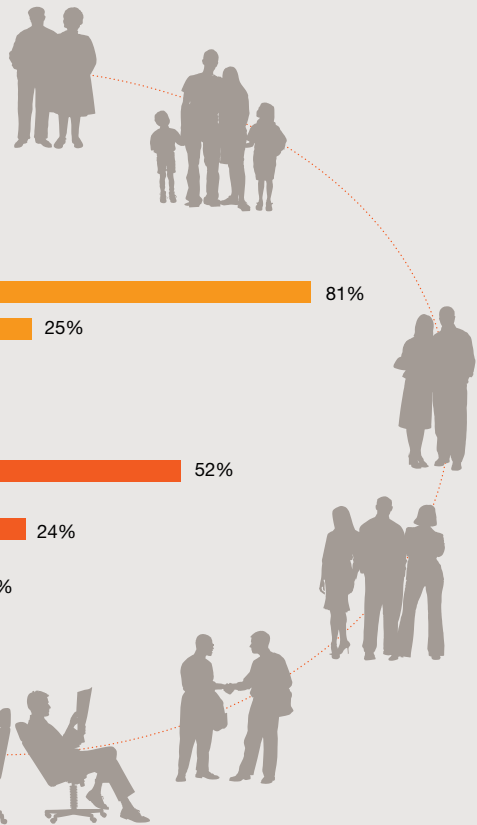
Difficult though choosing a successor may be, the task should not be avoided. Making a decision and communicating it sooner rather than later not only demonstrates the intention to keep the business going once the current leader steps down, but also helps to prevent surprises within the family and among other stakeholders. Once a successor is named, passed-over members are more likely to take advantage of other career opportunities (whereas, if they are kept in the dark, they might hang back, on false hopes — a potential source of resentment and family tension down the line). Meanwhile, family members who are currently working in the business will have a clearer understanding of their future responsibilities at the company.

Lifecycle of a family business

Take time to map it out

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

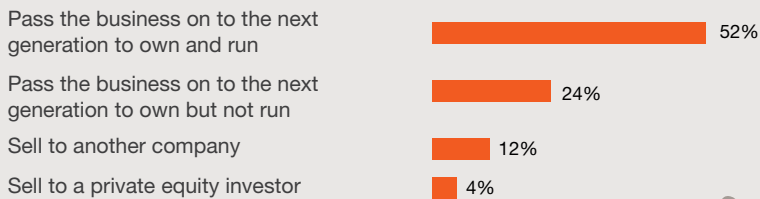
The earlier the owner develops the plan, the better. That's because the more time there is to prepare for succession, the greater the opportunity to maximize the business's value and reduce the risks involved when an owner or key employee exits the business.



US family business snapshot*



Contemplated form of ownership change



* Source: PwC Global Family Business Survey 2012/2013 (multiple responses allowed)

Q13: How many family generations have managed the company?

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

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

Percentages reflect responses from US participants in the survey.

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

- **Adequately train the successor:** If a family member is the identified successor, the individual should go through a substantial apprenticeship. This includes rotating through various upper-management positions in different business units across the company. Time spent at the company not only allows the successor-in-training to learn the business inside and out, but also helps the person establish his or her credentials with key stakeholders.

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

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

It may also be necessary to recruit new managers who have specialized skills essential to growing the business (e.g., people with emerging markets knowhow and skills in new technologies). This can prove difficult for some family businesses. Nearly half of the US participants in PwC's Global Family Business

Survey (2012/2013) ranked recruitment of skilled staff among their top three internal challenges. By presenting their company as a place where prospective employees will be nurtured and encouraged to grow professionally, family businesses can improve their odds of attracting and retaining top talent.

- **Distinguish between proper compensation and earnings distribution policies:** If only some of the members of a family help run the business, the owner may struggle to be fair to all. It serves the long-term interests of both the business and the family to acknowledge family members who make the greatest contributions to the company. This can be done by establishing a compensation policy that is commensurate with the fair value of their services. Nonparticipating family members can be given equity interests and possibly periodic dividend distributions in an effort to make all family members feel equal. When it comes to family businesses that are organized as flow-through entities for tax purposes, there may be family members who cannot afford to pay their portion of the business's tax liability. In those cases, tax distributions will need to be given careful consideration.

- **Determine appropriate ownership structure:** A good succession plan should take into account how suitable the business's current ownership structure is likely to be three or four generations later. For example, consider an S corporation. It is a good structure for many family businesses, allowing for the inclusion of family members who don't participate in running the business, as well as giving owners the flexibility to facilitate the transfer of wealth via certain trusts. However, the complex shareholder structure of an S corporation can become problematic as the family's various generations grow in size.

Brave new world

Grooming tomorrow's leaders for success in the global economy

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

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

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

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



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

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

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

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

- **Document all of the above in a formal, written succession plan and monitor it regularly:** A formal succession plan should be devised early in the existence of a business and then be revisited regularly. Early planning provides flexibility, allowing a family's succession strategy to alter course more easily if circumstances change. Tapping the experience of succession-planning advisors should help business owners maneuver through the steps discussed in this chapter and avoid potential pitfalls.

Planning for the transfer of business interests

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

A successful transition almost always hinges on a well-considered, written plan that clearly specifies the disposition of ownership interests in the business. The earlier the owner develops the plan, the better. That's because the more time there is to prepare for succession, the greater the

opportunity to maximize the business's value and reduce the risks involved when an owner or key employee exits the business. Early communication of the plan also gives a family time to resolve potential tension among its members (e.g., between those who are actively involved in the business and those who are not), which in turn should allow for a smooth transition when the new leader takes the helm.

A written plan should answer multiple questions, including these:

- Who should receive the ownership interests?
- When should the ownership interests be transferred?
- Should restrictions be placed on the transferred interests?
- How should the transferee be permitted to deal with the ownership interests?
- Should ownership and control (i.e., voting rights) be separated?
- Will the planned transfer cause conflicts that should be anticipated and addressed?
- What are the tax consequences of the planned transfer?

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

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

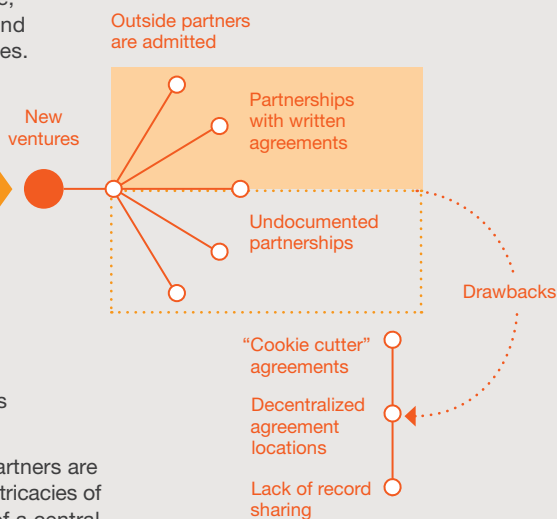
Put it in writing

It will make things easier in the long run

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



30-year partnership



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

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

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

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

Buy-sell agreement

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

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

In many cases, neither the entity nor the other owners have enough cash to purchase the entire business. Life insurance is sometimes acquired on the owners' lives and is owned individually or by a partnership or trust. The insurance proceeds can be used to fund the buyout, with any balance funded by the business entity through a redemption transaction or by the individual owners via other assets.*

* Note, however, that a redemption buy-sell agreement funded by corporate-owned life insurance is generally not a tax-efficient way to transfer ownership upon death. For more on this and other types of buy-sell agreements, see chapter 8 of this guide.

Sale to a third party

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

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

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

Initial public offering (IPO)

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

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

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

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

Special considerations

For the current owner to maintain some degree of control over and security about the future of the business, he or she needs to have a succession plan that is sufficiently flexible to respond to changing circumstances. Such flexibility can be achieved by incorporating into a plan different types of entity structures, trust arrangements, or other vehicles. It is critical that the business owner embed these features into the plan as early as possible.

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

- Recapitalizing the business into voting and nonvoting interests so that the nonvoting interests can be transferred during the business owner's lifetime to save taxes without relinquishing voting rights, and to provide alternatives for transferring wealth to family members not involved in the business
- Using valuation discounts to reduce the tax impact
- Obtaining a valuation appraisal from a qualified appraiser to support the value that is reflected in lifetime transfers of business ownership interests
- Selling ownership interests to intended transferees or to a trust for the benefit of the intended transferees, often in exchange for a note that provides interest for the seller
- Using lifetime transfer tax exemptions to efficiently transfer business ownership interests without incurring gift tax

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

Saving taxes through lifetime transfers

Lifetime transfers remain an attractive option from a tax perspective. Typically, the estate tax cost of transferring business interests upon an owner's death will be greater than the gift tax cost associated with lifetime transfers of the same business interests.

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

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

Choosing an operating structure

Economic conditions and the ongoing uncertainty surrounding future rates for income tax and estate tax are causing many private companies to reconsider whether their current operating structure is either appropriate or optimal. Many family businesses continue to evaluate abandoning their current structures for alternative ones, in anticipation of higher tax rates or to position themselves for the possible pursuit of an exit strategy, so that their families can realize value for the business.

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

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

It is also important to weigh tax factors. In this respect, a family generally seeks a business structure that will avoid tax at two levels — the entity level and the ownership level. It is important, therefore, to determine which of the various tax rates among entity types will be most advantageous to the family's business. Some family businesses, for instance, may find that the usefulness of the pass-through nature of Subchapter S corporations will be reduced by upcoming increases in tax rates for personal income (specifically, increases resulting when the extension of the Bush-era tax provisions expires at the end of 2012, as well as tax increases taking effect in 2013 as a result of the federal healthcare act). Consequently, certain S corporations may want to consider converting to C corporation status.

Other reasons that family-owned S corporations may be contemplating conversion to C corporation status include concern about the still-tight credit market, and the desire to have wider access to financing sources.

As of late, we've also seen some family businesses consider exchanging a corporate form for that of a limited liability company (LLC) — this as a result of having watched the worth of their businesses decline in the economic downturn. Such businesses find themselves sitting on significant unused losses or strapped with depressed business asset values. In such cases, the tax and transaction costs of a corporate liquidation may be reduced to a point where conversion to the more flexible LLC structure is a viable option for certain family businesses.

Adequate understanding of the implications of changing a business entity's structure requires careful consideration. Before undertaking a transition of this significance, a family business should first discuss it with experienced advisors. The general characteristics of the various types of business structures are summarized in the chart at the end of this chapter.

Tax factors in choosing an operating structure

The tax aspects of an entity's structure are vital considerations. The following questions should therefore be contemplated carefully:

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

These and other considerations should be carefully discussed with experienced tax advisors before a business changes its structure.

Conclusion

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

Overview comparison of entities

	Partnership	S corporation	C corporation	LLC
Liability	Unlimited for general partners	Limited to amounts invested and loaned	Limited to amounts invested and loaned	Limited to amounts invested and loaned
Double taxation	No	No (except for some built-in gains and passive income)	Yes	No
Pass-through of profits and losses	Yes	Yes	No	Yes
Limitation on entity losses deductible by owners	Net investments plus net income plus share of debt	Net investment plus net income plus loans to corporations	None deductible	Net investment plus net income plus share of debt
Subject to passive activity loss rules	Yes	Yes	Only certain small C corporations	Yes
Tax rates	Income taxed to owners at marginal tax rates, plus an additional 0.9% on active income from partnerships and 3.8% on investment income*	Income taxed to owners at marginal tax rates, plus an additional 0.9% on wages and 3.8% on investment income*	15% on first \$50,000, increasing to 34% over \$75,000 and 35% over \$10 million	Income taxed to owners at marginal tax rates, plus an additional 0.9% on active income from partnerships and 3.8% on investment income*†
Special allocations	Possible, if there's a substantial economic effect	No	Possible, if tracking stock is issued	Possible, if there's a substantial economic effect
Fiscal year	May be the year-end of majority interest or principal partners; alternatively, may be the tax year that provides the least aggregate tax deferral	May end up to three months earlier than the year-end of principal shareholders	New corporations — any fiscal year; Existing corporations — fiscal year with business purpose; automatic change permitted in certain circumstances	May be the year-end of majority-interest or principal partners; alternatively, may be the tax year that provides the least aggregate tax deferral
Tax-free fringe benefits to owners	Limited	Limited	Permitted	Limited
Public offering	Yes, but with some difficulty	No	Yes	Yes, but with some difficulty
Tax-free merger with corporations	Yes, under certain circumstances; additionally, possible tax-free incorporation available	Yes	Yes	Yes, under certain circumstances; additionally, possible tax-free incorporation available
Accumulated earnings tax	No	No	Yes	No
Personal holding company tax	No	No	Yes	No

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

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

Family meetings





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

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

Heightened need

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

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

Main points to discuss at a family meeting

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

Family meetings tend to address the following issues:

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

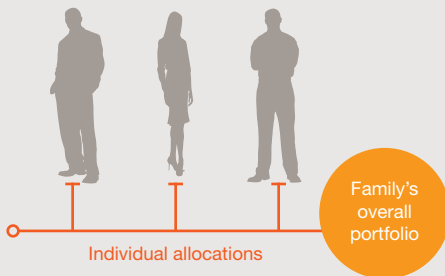
As changes occur in each of these areas, subsequent family meetings should be held to discuss how the modifications affect the family's vision for what it wishes to do with its wealth. Ideally, the family will already have a wealth mission statement. If it doesn't, the first family meeting could be devoted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

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

Family investing 101

Educating the next generation

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



These discussions will not only educate younger members of the family in sound investment principles, but also give them the basis for understanding the allocation made for each of them individually and how that fits in the family's overall portfolio.



In a special session, the family investment policies and fundamental asset allocation can be shared, along with an explanation of how they apply to the family's investments as a whole.

Younger generations will also learn how their investment allocation may be affected by their short- and mid-term needs, as well as by their long-term goals.

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

Family meetings present good opportunities for educating younger generations on how developments today will impact the family's wealth down the line.

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

Deciding who runs the meeting

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

If a family member chooses to chair or facilitate the meeting, it is best that the person isn't also the head of the family or the de facto leader. Instead, the facilitator role could rotate through family members, with a new person presiding at each meeting. Such an approach would promote a sense of inclusion and downplay hierarchical divisions. Regardless of who runs the meeting, he or she should be adept at moving past rough spots, working through any conflicts that arise, and making sure everyone is heard. Strong diplomatic skills are therefore required on the part of the facilitator. Ideally, that person will also be good at communicating things in plain English, particularly since some of the financial and tax matters addressed could be complex.

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

Who should attend?

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

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

Elements of a successful meeting

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

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

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

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

It is especially important to have a designated family member take minutes at the meeting so that there is a written record of the items discussed and important decisions reached. This serves a dual purpose — not only does it provide documentation in the event of a dispute, but it also preserves the family's history for future generations.

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

Outcomes

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

Conclusion

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

World view

Cross-border considerations for international families

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



Families that have members living outside the United States — whether year-round or part-time — or possessing dual citizenship will want to be alert to how wealth management plans under one country's jurisdiction might affect those devised elsewhere.

A sound plan in the United States isn't necessarily workable under another country's tax laws.

A photograph of four professionals in an office setting. On the left, a man in a dark suit and tie holds a black office chair. In the center, a man in a blue suit and light green bow tie stands. To his right, a woman in a tan sweater and grey pants sits on a desk. On the far right, a woman in a black dress and patterned cardigan stands. The text 'Family offices' is overlaid in orange script.

*Family
offices*



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

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

The comfort of continuity

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

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

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

- Review the advisor's résumé, qualifications, certifications, licenses, background, years of experience, and referrals.
- Call references, but also check to see if the advisor has any formal complaints against him or her.
- Request the tax and income profiles of the advisors' other clients. Those profiles will indicate whether your circumstances are the type that the advisor is accustomed to addressing.
- Determine the range of services the advisor provides.
- Find out how the advisor approaches financial planning.

- Ask how the advisor is paid for services.
- Assess an advisor's objectivity and the likelihood that particular products and services will be offered primarily because the advisor benefits from those offerings.

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

- Steer the team in crafting a wealth management strategy that you believe is appropriate for you and your family.
- Routinely provide you with a bird's-eye view of your wealth management plan so that you can gauge whether it remains consistent with your overarching goals.
- Ensure that the wealth management plan is well documented.
- Lead the team in implementing the plan.

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

Bird's-eye view

How a family office brings the big picture into focus



Craig manages a very successful family business for many years, one which he created himself. When his four children reach adulthood, he transfers a portion of the business to them and to trusts for their families.



Sale of business

Liquid assets

Family trusts

After decades of running and growing the business, Craig decides to sell it so that he can pursue other interests — chiefly charitable activities, with international aid as his main focus.

Apart from the business, Craig owned few significant, investible liquid assets. That has changed as a result of the sale. However, Craig has neither the time nor the expertise to manage his new liquid assets. He is also unsure of how best to pursue his charitable goals and what the tax implications might be.

Craig has various advisors. They include a tax accountant with cross-border expertise, an investment advisor, an estate planning attorney, and an insurance advisor. However, Craig feels that there is insufficient coordination among them and that they lack a complete understanding of his overall situation.

On a friend's suggestion, Craig establishes a family office to coordinate the work of his various advisors so that they function as a cohesive team.

The family office manages Craig's personal finances, as well as those of his family. It also manages the family's cash flow, oversees the activities of Craig's tax and compliance advisors, manages his charitable activities, and coordinates his ongoing estate planning. With this centralized approach, Craig feels that he and his family are well covered.



International charitable activities

Tax implications

Craig has advisors but their efforts are not coordinated

Craig's children are not interested in taking over the business — two of them and their families live overseas. They do, however, share in the proceeds of the business's sale, as a result of the earlier transfers.



Family office

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

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

Structure and creation

How a family office is structured depends, in part, on how many families it serves. There are two main categories of family offices: the single-family office and the multiple-family office. Beyond this distinction, family office structures vary with the nature of the families they serve. Some families may desire only basic administrative help, whereas others may want the family office to oversee asset management or perhaps even run their daily affairs. Services traditionally provided by family offices include the following:

- Coordinating and overseeing activities of external advisors
- Educating multigenerational families on wealth management and preservation
- Bookkeeping and accounting
- Income tax planning and compliance (domestic and international)
- Investment advisory and management services

- Trustee services
- Estate planning
- Family risk management (insurance)
- Handling of personal family matters (dispute resolution, cash flow management)
- Charitable planning
- Overseeing office technology and centralization of administrative functions
- Implementing and monitoring internal controls
- Gate-keeping (controlling which individuals and entities have access to the family and its information)
- Concierge (personal) services
- Managing noninvestment assets

Typically, the lead family member and a key outside advisor work together to decide the main objectives of the family office. Those objectives will dictate which services the office provides and how it is organized, staffed, and technologically supported. The legal structure (partnership, limited liability company, S corporation, etc.) will also have to be decided, as will the office's initial funding, anticipated operational costs, and allocation of costs among family members. Other key decisions concern the size and location of the office, who will run it, and how the office will keep the family informed of its activities.

Single-family office versus multiple-family office

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

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

Ongoing operations

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

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

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

One major distinction between an investment plan created by a family office and one created by an outside investment advisor is that the family office views the plan as part of the family's larger wealth management strategy.

Special considerations

One major distinction between an investment plan created by a family office and one created by an outside investment advisor is that the family office views the plan as part of the family's larger wealth management strategy — one that takes into account the family's tax planning needs and philanthropic goals, among other key considerations. Investment plans created by family offices also tend to deal with a much broader range of assets than do plans created by an outside investment advisor, including noninvestment assets such as private airplanes, artwork, yachts, and other valuable property. A family office's investment advisors recognize the importance of such nontraditional assets, especially when the family intends to pass them down over several generations.

Family office regulation

One intention of the Dodd-Frank Wall Street Reform and Consumer Protection Act was to bring hedge funds and private fund investors under the regulation of the Securities and Exchange Commission (SEC). To prevent unintended consequences, Congress created an exemption for entities that meet the SEC's proposed definition of a family office. If certain criteria are satisfied, a family office may meet this definition and therefore won't be required to register with the SEC as an investment advisor. Because the legislation's provisions are complex, due care should be taken in determining whether the exemption applies to an arrangement with a particular family office.

Tax considerations

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

A family office can also evaluate the tax implications of wealth transfer and estate planning. As discussed in this guide's chapter on estate and gift planning, the law governing estate taxes underwent a substantial overhaul in late 2010 and may change yet again at the end of 2012. Because a family office focuses on multigenerational wealth transfers, it readily assesses possible strategies such as yearly gift plans and the creation of various trusts. In doing so, it keeps scheduled or potential legislative changes in mind.

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

Conclusion

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

A man and a woman are in a meeting. The man is sitting at a desk, looking up and to the right, with his hands clasped. The woman is standing behind him, leaning over his shoulder, looking in the same direction. They are in a bright, modern office setting with a wooden bookshelf in the background. The text "Risk management" is overlaid on the right side of the image in a bold, orange, italicized font.

***Risk
management***



Ch8 Protecting your property and other assets from various risks involves more than just obtaining adequate insurance coverage.

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

Asset ownership

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

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

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

Trusts are especially helpful in protecting assets.

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

Assets held in joint name with a spouse

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

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

Revocable and irrevocable trusts

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

Self-settled asset protection trusts

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

The 14 states permitting self-settled asset protection trusts are Alaska, Colorado, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming.

Offshore asset protection trusts

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

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

Limited liability company or limited partnership

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

Insurance protection

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

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

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

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

Property and casualty insurance

Property and casualty insurance includes homeowner's insurance, auto insurance, boat insurance, and airplane insurance. Special rules apply to each type of coverage, and some states regulate auto insurance rates and coverage. It's important to find a well-respected agent to guide you through the process and help you price different coverage options. Recent tornado and flood disasters underscore the importance of understanding what various insurance options cover and do not cover.

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

Liability insurance

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

For airplane coverage, the key considerations are the ownership and use of the plane. Special Federal Aviation Administration (FAA) rules apply to airplane use. The liability coverage associated with airplanes is often linked to specific planned use, as defined by the FAA. Be especially careful when insuring aircraft used for mixed purposes — partly for business and partly for personal activities. Also realize that coverage eligibility depends on which person or entity owns the aircraft and who is doing the actual flying. Placing ownership of an aircraft in a limited liability company can significantly alter or invalidate liability coverage.

Medical insurance

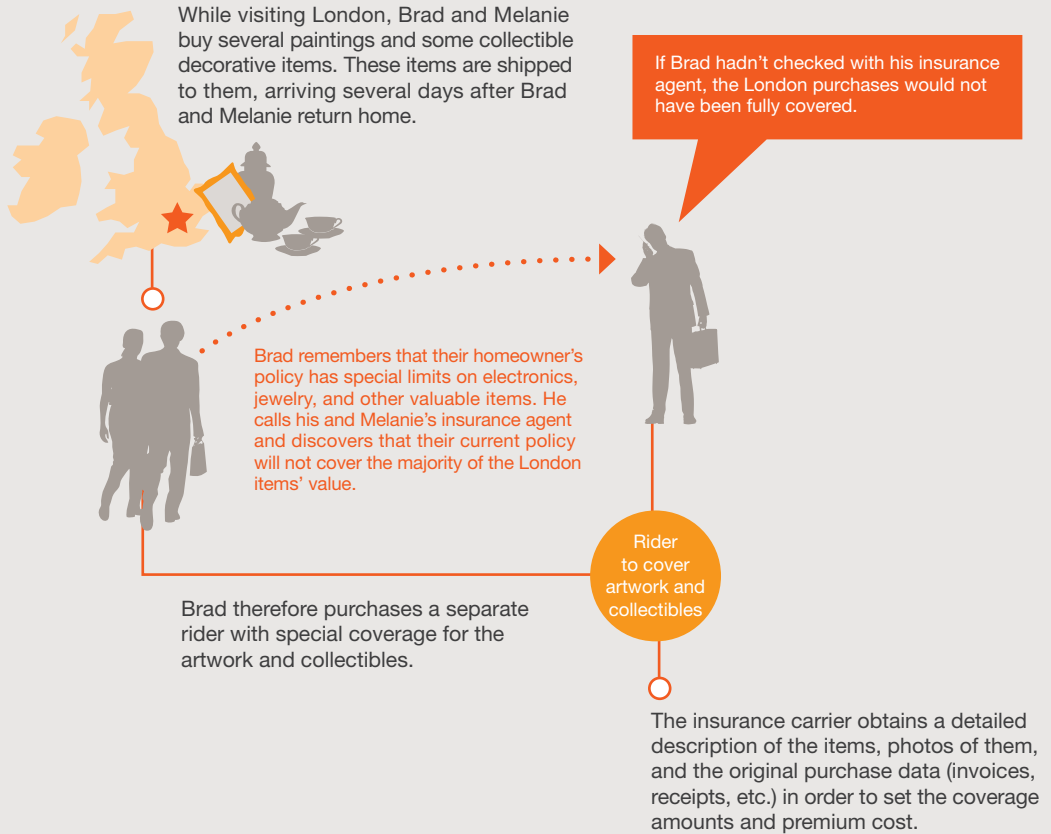
Healthcare costs continue to rise, along with the premiums many people have to pay for health insurance (under federal law, most people will be required to have some level of coverage, beginning in 2014). You should make sure you have the health insurance that best fits your needs. Increasingly, individuals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

Flexible spending account (FSA)

This is an employer-sponsored savings arrangement for medical costs. The costs are funded annually. The advantage of an FSA is that the contributions are made on a pretax basis. The disadvantage is that if you do not spend all of the funds that you've set aside, they revert to your employer. In other words, "use it or lose it."

Safeguarding your souvenirs

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



When funding an FSA, estimate the out-of-pocket costs you expect to incur during the next year — such as for co-pays or eyeglasses — and then arrange for that estimated amount to be withheld from your wages. Bear in mind that recent healthcare legislation eliminates the ability to use funds for over-the-counter drugs (such as aspirin). Also, starting in 2013, the maximum amount that can be set aside in an FSA will be limited to \$2,500 (this amount will be indexed annually for inflation). FSAs are not available to partners in partnerships or to shareholders in S corporations.

Health savings account (HSA)

This is a special account connected to high-deductible medical plans. Contributions to an HSA are tax deductible. Both employers and employees can make contributions to the account (subject to an annual limit). Income tax does not apply to distributions from an HSA, as long as they're used for medical expenses. For HSA distributions that are not applied to qualified medical expenses, there is a 20% tax penalty.

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

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

Disability insurance

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

Disability benefits are taxable if an employer either deducts or pays for the insurance premiums. Income tax does not apply to disability benefits if the premiums are not deducted or if the employee treats the premiums as wages. Generally, high-income individuals should *not* deduct the premiums — or else they should make sure the premiums are included in their wages, to minimize the tax impact of any benefits received.

It's important that the definition of a disability be job-specific rather than general. In other words, it is your current job that you cannot perform — not just any job. Often, the job-specific definition applies to the first several years and is followed by a general disability description. Another factor in disability insurance is that the longer the waiting period, the lower the premium. Likewise, the addition of a cost-of-living feature to benefit payments increases the premium.

Long-term-care insurance

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

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

Life insurance

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

Life insurance decision factors

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

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

- *How much insurance do you need?* Have you calculated what your family or other beneficiaries would need as an income replacement? Do you know what your future estate taxes are expected to be? How will your business affect your insurance needs?
- *Who should be insured?* Is it the main breadwinner? Both husband and wife? The whole family, including grandchildren? The business owner(s)?
- *Who should own the insurance?* It's typically not the insured party, the insured party's spouse, or the insured party's business. Most insurance is owned by a special life insurance trust or cross-purchase partnership.
- *Who should be the beneficiary?* While a spouse or children are typically named as beneficiaries, in many cases the owner of a trust or partnership is named.
- *Who should pay the premiums?* If a business owner is paying the premiums, there are a number of related income tax issues. And there can be gift tax issues if a life insurance trust is in place.

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

Trends in life insurance policy choice

People seeking temporary life insurance most often find that their needs are met via *level-premium term insurance*. With that type of policy, you pay the same amount for a set number of years (five to twenty years, depending on your age), and then the coverage ends. This is very cost-competitive insurance, without any additional features (adding features to life insurance makes comparing policies nearly impossible).

The need for longer-term life insurance used to be met by *whole life insurance*, which is a type of permanent life insurance that guarantees lifelong protection as long as you pay the premiums. This type of coverage is very predictable but inflexible. *Universal life insurance* — which is permanent life insurance, but with fewer guaranteed features — became popular in the 1980s and 1990s (a period of relatively high interest rates) because agents could engineer policy returns to illustrate lower premiums. Many of the interest rate assumptions built into the illustrations could not be sustained.

Variable life insurance — wherein the policy owner could choose the investments, much like a 401(k) plan — became popular in the late 1990s. Again, agents could engineer policy returns based on robust stock market returns, thus showing reduced premiums. Many universal life and whole life policies were surrendered in exchange for variable life coverage. With the major market declines in the period spanning 2001 to 2003, and again in 2008, the variable policy lost its popularity.

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

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

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

Life insurance diversification

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

Life insurance strategies

Insuring the breadwinner

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

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

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

Paying estate taxes

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

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

Under current federal estate tax laws, most state estate tax regimes, and most professionally prepared estate planning arrangements, the major estate tax is not due until the death of the surviving spouse. Thus, estate taxes usually are postponed until the survivor's death. To provide cash to pay estate taxes, the policy should insure both the husband and the wife but not provide a payout until the death of the survivor. As noted above, this type of insurance is known as second-to-die insurance, or survivorship life insurance.

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

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

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

Meeting the needs of businesses and their owners

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

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

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

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

Normally, the business owns and is the beneficiary of the key-person insurance policy. In the case of another employee replacing the insured key employee, many carriers will retain the existing policy (by having it substitute the new employee for the prior employee) rather than issue a new policy; however, such substitution usually has income tax consequences.

Most businesses, though quite valuable, can be illiquid in the hands of the estate administrator, whereas life insurance is liquid upon the death of the insured.

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

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

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

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

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

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

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

- **Avoiding corporate redemption arrangements:** A corporate redemption (buy-sell agreement) funded by corporate-owned life insurance is not a tax-efficient way to transfer ownership upon death. There are several reasons for this:
 - ▶ Distortion of the business value, because the insurance death benefit can be added to the value of the business for purposes of estate tax
 - ▶ Potential corporate-level income tax on the insurance death benefit (alternative minimum tax)
 - ▶ Complicated tax rules associated with purchasing stock from the estate, especially when payments take place over time
 - ▶ No basis increase in the stock held by the remaining shareholders

The easy way doesn't always pay

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

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



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



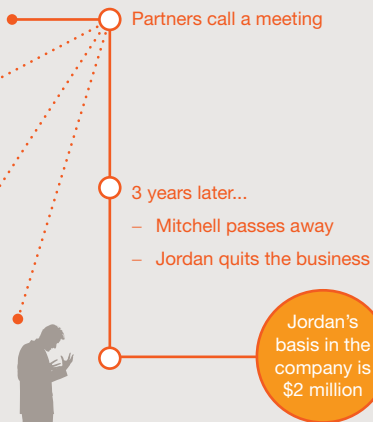
The insurance agent nods his head and points out that under such an arrangement the company would be both the owner and beneficiary of the policy.

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

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

The estate is audited. As a result of the audit, the value of the stock is increased by \$1,250,000 (Mitchell's share of the life insurance), and Mitchell's widow must pay \$562,000 of additional estate tax.

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



Jordan realizes that the seemingly quick and easy redemption done with Mitchell's widow has created a chain of unfortunate tax events. If he and the other two surviving partners had purchased Mitchell's shares from his widow directly (a cross-purchase arrangement) she wouldn't have had the \$562,000 estate tax issue, and Jordan's income tax gain upon the sale of the stock might have been \$1,000,000 less.

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

- **Funding cross-purchase agreements:** A more tax-efficient (and flexible) arrangement than the traditional redemption agreement is the cross-purchase agreement. In this arrangement, the other business owners agree to buy the deceased owner's shares. The company itself is not a party to the agreement.

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

This arrangement has the following advantages:

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

The types of policies used for funding cross-purchase arrangements typically are permanent types of life insurance (since these arrangements generally continue for a long time), such as whole life, universal life, and variable life insurance.

Funding nonqualified deferred compensation arrangements

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

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

In the typical arrangement, a corporation purchases life insurance policies on the lives of the participants in the executive benefit plan. Policy premiums are paid each year and reduce current earnings, but they are not deductible for income tax purposes. New tax laws require that companies obtain an executive's permission before purchasing the policy, and then provide the IRS with information on the policy when the business files its annual tax return. Policies on individuals who are not executives or employees at the time of their death have less favorable tax consequences.

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

As a practical matter, such arrangements require careful bookkeeping and can create cash flow issues for a company, due to the mismatch in cash flow payments: Premium payments and executive benefit payments are cash outflows in the early years, while death benefit payments are cash inflows much later. In addition, it's sometimes difficult to tell whether you have an economically successful arrangement until all of the insured executives are dead. The arrangement is especially problematic if there is turnover in the executive ranks, which necessitates turnover in life policies, thereby defeating the income tax advantages.

Life insurance as an investment

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

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

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

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

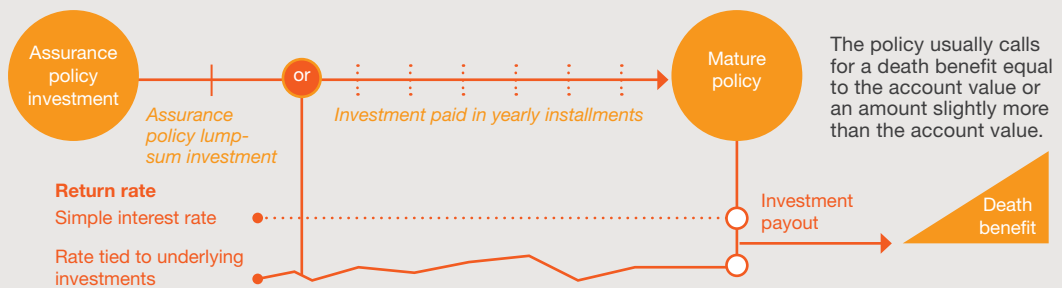
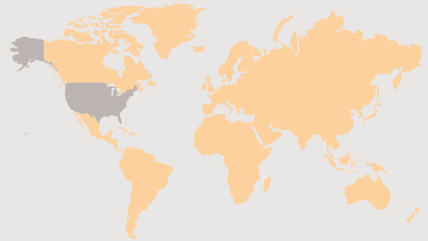
Foreign life products as an investment

Compelling but not clear cut

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

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

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



What's clear

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

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

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

What's not clear

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

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

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

** PFICs include foreign-based mutual funds, partnerships, and other pooled investment vehicles that have at least one US shareholder. Most investors in PFICs must pay income tax on all distributions and appreciated share value, regardless of whether capital gains rates would normally apply.

Working with your insurance advisor

Insurance planning is an important part of and critical tool in most financial, retirement, and estate plans. Therefore, make sure that you have an advisor who not only understands your particular insurance requirements, but also appreciates how they relate to other aspects of your wealth management plan.

You may find it makes sense to have two different insurance advisors — one for property and casualty insurance (homeowner's, etc.) and another for life insurance.

Your insurance advisor(s) should be clear on how a recommended insurance product fits your needs. The type of policy, the riders attached to the policy, the amount of insurance, the stability of the issuer, and the price for the policy should be reviewed by you and, if appropriate, by other key advisors on your wealth management team. If you already have policies in place, ask an advisor to review them to see whether all are still appropriate for your needs.

It is good to have an advisor who understands your entire insurance picture. Such an advisor can help to ensure that:

- All your insurance needs are being met
- Costly redundancies in your coverage are eliminated
- Premiums are sufficient to continue your life insurance coverage without the policy lapsing
- Risks that could diminish your wealth are minimized

For example, does one disability policy cancel out or overlap another? Does it make sense to replace one policy with a different, updated one? Does your umbrella policy truly fill the gaps in your auto and home policies? Does your property insurance cover all of your jewelry, artwork, and other collectibles? These are questions that you and your insurance advisor will want to address.

Make sure your advisor not only understands your particular insurance requirements, but also appreciates how they relate to other aspects of your wealth management plan.

Revisiting your coverage

Your insurance needs 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 (1) review the policy's performance to date and (2) determine the policy's future performance based on current rates. A periodic review of your permanent life insurance should help ensure that your policy doesn't lapse.

Conclusion

Because effective risk management is a critical component of any sound wealth management plan, you'll want to approach it with due care. While many risk-management options are out there, none should be pursued hastily. By taking ample time to make wise decisions about insurance policies and forms of asset ownership, you can better mitigate the risks posed to your health and wealth, helping to ensure longevity for you and lasting value for your family.

About PwC's Personal Financial Services

Helping build your wealth and protect it through generations is important to you, and to us. PwC's Personal Financial Services professionals make sure your wealth management plan is customized to meet your personal, business, and family goals.

We help you preserve and grow your wealth through objectively and carefully considered investment strategies, estate and gift planning, charitable giving, personal tax preparation, and business succession planning.

How we deliver these services to you — one-on-one, via a family office, or through a financial program for executives and employees — will depend on your particular situation and preference. One size does not fit all. When the time comes to take this personalized approach to managing your wealth, we are here.

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