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The Taxman Cometh — Limit the Amount He Takes

By Julie Crawshaw

A recent Worth survey of 259 affluent individuals revealed that their No. 1 financial concern is not the state of their investments — it's taxes.

Small wonder. With all the social engineering that's going on in Washington these days, investors have good reason to worry that the money they worked hard to earn will go for estate taxes instead of to their heirs.

Even though estates up to $3.5 million for an individual and $7 million for a couple are still exempt from federal estate tax, heirs can be required to pay state estate taxes and income taxes on retirement accounts, which can create significant drains.

An irrevocable life insurance trust (ILIT) can stop that from happening.

Using an ILIT can be an excellent solution, says Adam Sherman, president of Firstrust Financial Resources. Here's another benefit: An ILIT can provide liquidity for the estate assets because it is held outside the estate.

"It's a tested strategy that's held up over many years of tax law changes," Sherman says. "Besides which, whole life insurance has proven to be an excellent investment when owned to actuarial mortality, usually yielding a 5 percent to 7 percent return."

When someone with an ILIT dies, the amount of the insurance policy in the trust becomes available immediately to the designated beneficiaries.

Many people think that the trusts for life insurance proceeds pay estate taxes, but they actually don't, says Carlos Lowenberg Jr., CEO of Lowenberg Wealth Management Group.

What ILITs actually do is purchase assets from the estate, and the estate uses the cash it receives from the purchase to pay the taxes.

"An irrevocable life insurance trust replaces wealth that has been dissipated from the trust," Lowenberg says. "It provides liquidity when liquidity is needed and acts as a risk management tool."

ILITs also can be used to reap tax savings before those who are insured die.

For example, many of Lowenberg's clients with $20 million to $30 million estates plan to leave their money to not-for-profit organizations.

"In many cases, people who plan to leave a portion of their estates to charity can take income tax deductions for their future gifts now and use a portion of their tax savings to pay the premiums for the life insurance in their ILIT," he says.

"Use your ILIT this way, and you can get around the tax system and build a legacy at the same time," says Lowenberg. "Estate planning is complex, but it's

Key Points

- Tax Time is Coming; Limit What You Owe
- Life Insurance Trusts Are Effective
- Pick Your Trustee With Great Care
- More Tax-Reduction Strategies to Consider
- Picking a Wealth Manager in Tough Times

Plus

- ETFs Are Your Hedge Against Inflation
- Keep an Eye on Commodities

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kind of like driving a car: You don't have to know how the engine works to make the car go for you," Lowenberg says.

Because these trusts must be set up and managed in a way that dots every "i" and crosses every "t" if their benefits are to be realized fully, both Lowenberg and Sherman recommend using an estate planning attorney to draft the trust document.

In addition, savvy investors will assemble a team of specialists that includes an attorney, a financial planner, and a life insurance specialist.

Include Every Beneficiary From the Start

"Life insurance trusts are very, very efficient and effective, but like any estate-planning tool, they must be done right and make sense for the client, and every client is different," says Maryland estate-planning attorney Gary Altman.

For example, Altman points out that all beneficiaries of these trusts must be identified when the trust is set up. Parents and grandparents setting up an ILIT should write one that includes children and grandchildren, and be sure to write one that includes the phrase "here and after born."

Single people who expect to marry should make sure to include a provision for a future spouse to share in the proceeds when they set the trust up.

And although you can fund the trust by transferring an existing life insurance policy to it, moving an existing policy can cause the IRS to disallow the trust if the insured dies within three years of set up.

Funding the trust with a new policy is a better strategy.

ILITs are especially useful when estate assets are relatively illiquid, Altman notes, because there might not be enough cash available to retain the assets unless an ILIT is present.

For example, consider the case of an insured person who owns 20 percent of a business that's worth $130 million, making his share $26 million. "If he died tomorrow and the business couldn't buy his shares, his heirs would retain his interest in the business," Altman points out.

"They'd be required to pay a tax of at least 45 percent on everything above $3.5 million. Some states tax at a rate that's effectively 52 percent, and taxes are due nine months after the estate owner dies, with limited exceptions."

Crummey Letters Are Recommended

However, just creating an irrevocable life insurance trust isn't enough, says Jonathan Gassman CPA/CFP, a partner with Gassman, Golodny. Proper trust administration is vital to the successful outcome of keeping the death benefit or proceeds out of the estate.

"You'd hate to think that, after you were gone, your heirs had to pay taxes on the trust proceeds because your trustee didn't do these things," he says.

One of an ILIT trustee's most important tasks is notifying the beneficiaries of their withdrawal rights in writing when annual premiums are paid, Gassman says.

Such notifications commonly are referred to as Crummey letters, and the beneficiaries must acknowledge, in writing, to the trustee that they received them.

"A lot of people don't bother with Crummey letters, and that's absolutely wrong because they're necessary to prove that the gift is present interest," Gassman says. "Without proof that Crummey letters were received, the IRS can move in."

Under normal gift tax rules, Gassman explains, donors can make a federal tax-free transfer to each beneficiary up to $13,000 per year, provided that the recipient has an unfettered right to the money immediately.

However, because money placed in an ILIT to pay insurance premiums constitutes a future interest, it qualifies for the gift exclusion only if beneficiaries have the right to withdraw it in the present.

"A Crummey letter allows donors to let their children know that the money's there — but if they take it out, the policy proceeds won't be there for them when the insured dies," Gassman says.

ILIT trustees have additional responsiilities. For example, they must file annual gift tax returns, keep a separate bank account with a separate federal identification for the trust, pay premiums when they're due, and keep scrupulous

records. That's why the choice of a trustee is so crucial.

Pick your trustee with great care, and make sure the trustee you pick is aware that the job comes with a lot of liability, advises Matthew Tuttle, president of Tuttle Wealth Management.

Pick Trustees Carefully

"The trustee's fiduciary responsibility is huge," Tuttle says. "All the duties of monitoring investment trusts also apply to people monitoring life insurance trusts."

"Let's say you're the trustee for a life insurance trust funded by a $5 million policy whose insured dies, and the insured's heirs receive a check for $5 million — but one of them decides that for the amount of money the insured was paying the check is too small," Tuttle says.

The trustee points out that, when the policy was taken out, the insured weighed 300 pounds, had high cholesterol, and smoked two packs of cigarettes a day. The heirs reply that two years after acquiring the policy, the insured lost weight, stopped smoking, began running marathons, and was in much better shape.

Then the heirs do some checking and discover that the insured's improved health meant that the trust could have purchased twice as much insurance for the same amount of premium money. They subsequently sue the trustee for the "missing" $5 million.

Make sure that the trustee you choose has all the tools necessary to monitor the policy in your life insurance trust, Tuttle counsels. "Life insurance is not a transparent product, and without help it's impossible for consumers to pierce the veil," he notes. "Every agent will tell you their policies are the best."

That's why Tuttle's firm uses a patented tool from The Insurance Advisor that gives an objective view of their policy and reveals potential problems.

"I do a lot of expert witness work," Tuttle says. "Before the Insurance Advisor came along, it wasn't easy for me to prove the trustee didn't do what he or she should have done. Now all I do is put some numbers into the program and I have an answer."

The Insurance Advisor, which the New York State Bankers Association has approved for use in bank trust departments and the American Institute of Certified Public Accountants has endorsed, does for life insurance what Morningstar does for mutual funds, Tuttle says, and will eventually revolutionize the ILIT arena.

In theory, transferring property to a grandchild rather than to a child means avoiding one layer of estate and gift tax. However, a generation-skipping tax (GST) is imposed on such skips in addition to estate and gift tax on the transfer, Gassman says.

One of Altman's clients left a life insurance policy larger than $5 million for the benefit of her grandchildren.

"If we hadn't planned for it properly, there would be generation-skipping tax on the life insurance even if there was no estate tax on it," Altman says.

"Using a life insurance policy, we were able to leverage the GST exemption so that, when the proceeds come into the trust, they are GST tax-free," he says.

Here's how it worked: The insured gave a $10,000 contribution to the trust, which Altman and his client allocated as a generation-skipping exemption. That made the trust totally exempt from the generation-skipping tax forever.

Afterward, money was lent to the trust, so the client could make additional $13,000 gifts to her children and grandchildren.

An irrevocable trust established in one of the many states that have repealed the rule against perpetuities could continue forever without either the current or future heirs having to pay taxes, Altman says.

Additional Tax-Reduction Strategies to Consider

Life insurance trusts, however beneficial they can be, are only one of several excellent tax reduction and tax avoidance tools available.

In addition to ILITs, a well-thought-out estate plan will use at least three of the following five tools that sometimes are overlooked when planners and attorneys don't focus on business tactics as well as legal issues.

• **Sell Your Heirs the Assets Now.** Many times, assets that parents or grandparents hold can be sold to heirs in order to reduce the tax on the estate in the future. Typically, such sales are

arranged for assets that are growing rapidly in value, thereby adding to the potential estate tax liability as the asset's worth grows over time.

To avoid boosting the tax bill, a sale is structured in which the asset is "sold" for a note to a trust for the benefit of the heirs.

Now, instead of a rapidly appreciating asset, the estate holds a note at a government-approved interest rate, which typically is much lower than the rate of growth of the asset.

"Many of these sales are indeed real sales," Lowenberg says. "Other times, they are exchanges for annuity payments in a codified transaction known as a grantor retained annuity trust."

Using such sales and annuities is considered a "freeze" technique because they exchange the asset for a note or stream of annuity payments that remain in the estate, just as when a mortgage holder receives regular payments from the mortgagee.

There are roughly 20 different ways to manage asset sales —from grantor retained annuity trusts to self-canceling installment notes, which are house trusts in which the owner sells the home but continues living there rent-free for a certain number of years, Lowenberg says.

"Many ways of managing these sales are codified, meaning they can be found in the IRS codes," Lowenberg says. "And when you use a codified method, even if you make a mistake, there's no penalty."

Other ways of handling sales are simply business concepts, as when you might sell a business you own to your kids before it becomes worth a lot more.

- **Reduce Asset Values.** Another way to reduce estate tax is to reduce the value of the taxable asset.

Methods for achieving discounts vary, but they all involve impairing the asset so that it is not as valuable, such as putting some asset restrictions in place.

For instance, a family business might be a limited partnership that allows only the general partner, who typically owns only a small percentage, to make all decisions for the company, thus reducing the control that limited partners would hold.

In this case, the majority of the business might be discountable because the limited partners do not have rights to sell their assets or receive income.

When those assets are transferred down a generation, they can be valued at a lower price than they would have been without impairing heirs' rights to them.

"A simple analogy for this tactic is to compare voting and nonvoting shares in a corporation," Lowenberg notes. "It's easy to see that the voting shares, all else being equal, would be worth more, and the IRS of course recognizes that difference in value."

Under current law, people can give up to $1 million that will be estate- and transfer-tax-free during their lifetimes.

Another example: Your heirs might get restricted ownership rights such as nonvoting rights in a business while you are still alive, then receive the voting rights when you die.

Or you leave them all the nonvoting shares in your will but they have to purchase the voting share to have full control of the asset. Then you have given your heirs the asset without a big tax bite because control of the nonvoting shares all passed to them at a much lower value.

- **Give Your Heirs Gifts.** Simply making gifts to heirs during your lifetime should reduce the taxable estate at death. Gifts of $13,000 or less per recipient per year can be made by each estate holder and will reduce the value of the estate by the value of the gift.

This provides another advantage: The earnings on the gift accrue outside the estate, exactly as when gifts made to ILITs provide leverage.

Under current law, people can give up to $1 million that will be estate- and transfer-tax-free during their lifetimes.

- **Donate to Charities.** Assets given to charity either during life or at death avoid estate tax inclusion.

Most people, when asked whether they want

to give to charity, initially want to give very little at death because they don't want to lower what their heirs will receive.

At first that sounds logical because taxation reduces the amount of the inheritance by the tax rate — about 50 percent — and giving something to charity is a 100 percent donation. However, with planning, many families have discovered that philanthropy actually can add to the family's overall wealth while helping to eliminate estate taxes and building a legacy.

Many types of charitable gifts can be leveraged because the income tax deductions for them are available during life.

"In every case I have seen, it is possible to completely eliminate estate taxes using a combination of philanthropy and the previously mentioned techniques to create an estate plan that leaves as much as 100 percent of the estate to the heirs, leaves what would have gone to taxes to charities of the donors' choice, and reinforces the values and beliefs of the estate holder," Lowenberg says.

• **Consider Opportunity Shifts.** Although opportunity shifts are commonplace in family wealth plans, many financial advisers unfortunately fail to appreciate the tax advantages they provide.

"Estate planning has always been about the business of moving wealth in the most efficient and effective manner," Lowenberg says. "Opportunity shifts provide a great way to move the value of your accumulated wealth into future generations."

An example of an opportunity shift would be a real estate developer who owns some property and is developing a project while holding it in a trust for the benefit of his heirs.

Using the estate holder's co-signature, the trust might even borrow money from a bank to fund and complete the development. Though the trust asset may have a small gift value associated with it, the amount pales when compared with the amount of wealth now in the estate of the heirs once the development is completed.

Another example: a business owner whose plans for expansion include opening a branch in a new location or creating a new division of the company. The new branch or division can be set up under the ownership of a trust for the heirs or even directly under their ownership, thereby expanding family wealth without increasing the estate tax burden.

Those whose estates include an existing business can open a company branch in another city and give it to their heirs to run. Those whose estates include commercial land can create business partnerships with their children and give some of the land to the partnership and lend the children money to build commercial businesses on it.

Using every means available for reducing and avoiding inheritance taxes makes your heirs' lives financially easier when you die — and sends the taxman on his way with as little money as possible. ■

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Picking a Wealth Manager in Tough Times

By Dan Weil

Extremely volatile actions in financial markets during the past two years, and scandals such as the Bernie Madoff debacle that cost some investors their life savings, have increased the importance of choosing a wealth manager carefully.

You can start by asking trusted friends for referrals, the experts say. "One of the most powerful tools is talking to people you know," says Diane Pearson, an adviser at Legend Financial Advisors in Pittsburgh.

"How have they been treated by their advisers? Do their advisers contact them to let them know what's going on?" she says.

"You want someone who will listen to your fears as well as be there for you during good times," says Pearson.

You also can find advisers through reputable groups such as the National Association of Personal Finance Advisors and the Financial Planning Association. Both groups' Web sites include a search function to find advisers in your area and a list of questions to ask them.

Contact more than one adviser so you have some basis for comparison. Many advisers have certifications that enhance their qualifications, such as certified financial planner, chartered financial analyst, or certified public accountant.

Vet Advisers Thoroughly

Registered investment advisers must file what are called ADV forms to the Securities and Exchange Commission (SEC). These forms include basic information about the adviser, including any disciplinary action.

You can check with your local SEC office to see someone's ADV form, or you can ask the adviser for it. If he is unwilling to show you the form, that's a reason for caution.

For those who aren't a registered investment adviser but work for a brokerage firm, you can check their background at FINRA.org.

Here are some of the questions you'll want to ask potential advisers:

• Does their firm use an outside custodian to hold your portfolio? "That's the most obvious one in the aftermath of the Madoff scandal," says Charles Lieberman, chief investment officer at Advisors Capital Management in Hasbrouck Heights, N.J.

"If the firm is its own custodian (as was the case with Madoff), that should stop the conversation right there. They should be using a reliable, well-known, third-party custodian."

• How much experience do they have? "You want to find someone who has experience through tough times and good times," says David Gotaas, a retired Chicago real estate developer who now is an investor and philanthropist.

• Does the wealth manager serve clients who have a similar financial profile to yours? "Our clients are generally people worth $5 million to $10 million," says Tony Decello, financial advising director at Deloitte Tax in Cleveland. "You want managers who serve people like you."

• What is the manager's investment approach? "If they're using packaged products rather than designing their own portfolios for you, they're not really managing your money," Lieberman says.

• What investment products will be available to you? Beware of advisers who want to sell you only their own firm's products. "You want people with absolute independence and no conflict of interest," Decello says. "They should only be getting their money from you."

• What are the fees? Most experts recommend against advisers who charge commissions for each transaction, because that gives advisers an incentive to make more trades than necessary in their clients' accounts. "Money managers should

have a long-term perspective, and turnover should be low," Lieberman says.

So experts say you generally are better off choosing advisers who charge a set fee for managing your assets. That fee generally will total between 1 percent and 2 percent of your asset total each year. In general, the bigger your portfolio, the smaller the fee in percentage terms.

• What is the adviser's investment track record? "That will be difficult to interpret, partly because different clients have different needs, and a manager should reflect those different needs," Lieberman says.

Advisers should use different benchmarks and produce different performance for different portfolios. Make sure the advisers use an appropriate benchmark. They shouldn't be comparing a portfolio of small-cap stocks to the Standard & Poor's 500 Stock Index, which encompasses large-cap stocks.

• How do the advisers measure their performance? Look for an investment manager whose measurements comply with Global Investment Performance Standards.

"It's easy to cheat in measuring performance," Lieberman explains. "You can take some clients whose portfolios haven't done well and find a reason to exclude them from the performance record."

Advisers also can choose time cycles that eliminate periods of poor performance. The performance standards "don't permit you to cherry-pick," Lieberman says.

It's important to find out what a manager's returns are after fees, Decello says. "Most won't report that unless you ask them."

When you're interviewing a potential adviser, observe how much the person is asking about your goals and needs. "If they're just trying to sell you on their firm and not asking about you, that may indicate they're more concerned about their firm and themselves than you as a client," says Legend Financial's Pearson.

Money managers obviously can't build an appropriate portfolio for you without learning about your financial situation and risk tolerance.

"Money managers should be asking a lot of determined questions about financial issues associated with a client's income and spending needs," Lieberman says.

Trust Is Essential

Of course you want someone you trust. "I've met a lot of advisers whom I would trust, but I've met a lot who I wouldn't," says Scott Pardee, a veteran Wall Street executive who now teaches economics at Middlebury (Vt.) College. "They have angles they want you to play."

And you should have an extensive discussion of what your portfolio will look like.

"You may be interested in socially responsible investments," Pardee says. "A lot of people will offer you those portfolios. But your definition of socially responsible investments may be much different than theirs. So you'd want a customized approach to your portfolio."

Communication with your financial adviser is very important. "Do they send you a readable statement?" says the investor Gotaas. "If I can't tell what they're investing in, I stay away from it."

Investors with a sizable portfolio might consider using more than one money manager, even though that bucks conventional wisdom, he says.

Gotaas also diverges from the consensus opinion that you should avoid financial advisers who try to time financial markets. "I believe very much that timing has a lot to do with what your return is," he says.

Once you find a wealth manager whose investment style and strategy match your needs, then you need to keep your expectations realistic, experts say.

"Recognize that, if the guy is true to his style and strategy, there will be periods — sometimes years — that his style and strategy won't work," says Chris Litchfield, a retired hedge fund manager in Stamford, Conn.

As a final element of the selection process, experts say you should ask potential wealth managers to refer you to several of their clients. That way you can get an insider's view.

" It's important to have referrals from clients similar to you to make sure that you'll be happy, says Deloitte's Decello." ■

Worried About Inflation? ETFs Are Your Hedge

By Forrest Jones

All of the money printing that has come with the bailouts will bring inflation back, say market watchers.

The federal deficit is already at $12.3 trillion, according to the U.S. National Debt Clock. The debt-to-GDP ratio is more than 84.2 percent, and experts expect it to exceed 100 percent.

Investment guru Marc Faber said in a recently published interview that inflation could climb as high as 20 percent.

So how do you hedge against inflation?

Exchange-traded funds (ETFs) tied to commodities, says Sean Hyman, an international currency expert.

When inflation rises, currencies often weaken and investors generally seek safety in commodities like gold, silver, copper, or wheat.

Some investors should consider GLD, an ETF tied to gold, or SLV, which invests in silver, he says.

There are other ETFs out there that invest in baskets of commodities such as DBC.

"It's a good and general and broad way to tackle inflation," Hyman says.

Other ETFs that perform well amid rising inflation include DBA, which invests in agricultural commodities, as well as FCG, which is tied to natural gas, the prices of which should be due to rise.

For those worried about inflation, there are ETFs tied to countries that produce commodities.

Take Australia. The FXA ETF is pegged to the Australian dollar, which will do well amid a commodities rally since the country is a large producer of raw materials.

Demand for Australian commodities means demand for the currency, which should strengthen.

Brazil is another heavyweight in the commodities world, exporting metals and food to growing economies such as China.

The EWZ ETF tracks Brazilian stocks of companies that export commodities.

Raw materials are a wise bet as the U.S. Federal Reserve prints more and more money to bail the country out of the recession and as rising economic superpowers such as China and India demand more and more commodities to grow, Hyman says.

"All that requires copper and ore, in general."

Other experts agree that a commodity-driven economy makes a good investment these days.

Keep an Eye On Commodities

"I personally like Brazil," says Mike Carr, chief market strategist at Dunn Warren Investment Advisors in Greenwood Village, Colo.

Brazil is not only rich in commodities but also an emerging-market economy, which means it has a growing consumer class.

Also, stay alert for investment opportunities other than gold. Sugar is outperforming gold, and copper is a great buy, too, Carr says.

Carr agrees that inflation will become an issue with the U.S. economy, so investors should look for ETFs and their sisters, exchange-traded notes (ETNs). Unlike ETFs, which deal with assets like equity, commodities or an index, ETNs purchase notes and debt instruments.

Investors also should look at Australia — and not just because it produces commodities, Carr says.

The country trades heavily with China, which makes its currency a good investment opportunity.

There are many investment opportunities out there that do well against inflation but only Treasury Inflation-Protected Securities are directly tied to inflation, says Paul Justice, an ETF strategist at Morningstar.

There is a high probability that ETFs will provide inflation protection, but their performance is not guaranteed in any matter, Justice says.

Still, people will flock to ETFs, especially gold, the classic hedge against paper currency.

"The most popular choice is SPDR Gold Trust," says Justice.

Next up is iShares Silver Trust (IAU), he says.

"It should be noted that silver isn't a foolproof inflation hedge. Unlike gold, silver has industrial applications, which means it's more likely to fluctuate with economic ups and downs," he says. ■