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Inheritance protection plans

Thoughtful planning may create a lasting legacy.

Those who have built wealth during a lifetime of hard work are rightfully concerned about how best to use that wealth for family financial security. As has been noted often, the wealthy want their heirs to have enough to be able to do anything — but not so much that they don't have to do something. Now more than ever, a family fortune is something to be protected and nurtured.

What is the answer? How can wealth be conserved and deployed on a long-term basis for the benefit of heirs? Trusts could be the answer for many families.

Trusts come immediately to mind when planning for a surviving spouse or an heir who is a minor. With a trust, one gets professional investment management guided by fiduciary principles. For young beneficiaries, a trust can provide for education funding and for getting a good financial start in life.

But what about when the children are fully grown, established in their careers, and financially mature, in their 30s or even 40s? Even then, trust-based planning will be an excellent idea for many affluent families.

Trusts in action

Among the key benefits that can be built into a trust-based wealth management plan are the following:

Professional investment management. A significant securities portfolio is a wonderful thing to have, but it requires serious care and attention, especially when economic growth is weak, interest rates are low, and taxes are uncertain. How can adequate income be provided to beneficiaries without putting capital at risk? What is the best balance between stocks and bonds? How can portfolio management be made more tax efficient? These sorts of questions will be addressed by corporate fiduciaries, such as us.

Creditor protection. One of the most frequent questions that we hear is, "How can I keep my money and property out of the hands of my son-in-law (or daughter-in-law)?" The inquiry is understandable, given the high divorce rate in this country. Our answer: Use a trust to own and manage the property, and give your heir

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the beneficial interest in the trust instead of the property. A carefully designed trust plan can protect assets from improvident financial decisions by inexperienced beneficiaries and safeguard assets in the event of a divorce.

Future flexibility. Parents typically have a fuzzy definition for treating their children "equally." As each child is unique, his or her needs may require financial support that is out of proportion to that of siblings. By utilizing a trust for wealth management, one may give a trustee a similar level of discretion, permitting "equal treatment" on something other than gross dollar terms. The trust document may identify the goals of the trust and provide standards for measuring how well the goals are being met for each of the beneficiaries.

Capital foundation. Federal estate taxes are slated to zoom in 2013 and later years, with higher tax rates and much lower (by recent experience) exemption amounts. A trust may provide a capital foundation that avoids successive imposition of transfer taxes and, thus, keeps more hard-earned wealth in the family.

Our invitation to you

We specialize in trusteeship and estate settlement. We are advocates for trust-based wealth management planning. If you would like a "second opinion" about your estate planning, if you have questions about how trusts work and whether a trust might be right for you, we're the ones you should turn to. We'll be happy to tell you more. ☐

Testamentary trusts

A great variety of wealth protection strategies may be implemented with careful trust planning. Among the choices to evaluate:

Type of trust	Comments
Marital trust	Several options are available to provide lifetime asset management and financial protection for a surviving spouse.
Support trust	For an adult child who needs a permanent source of financial support, with the trust principal protected from the claims of creditors, a support trust may provide a solution. The beneficiary's interest is limited to just so much of the income as is needed for his or her support, education, and maintenance.
Discretionary trust	The trustee has sole discretion over what to do with the income and principal, just as the grantor does before the trust is created. The beneficiary has no interest in the trust that can be pledged or transferred. When there are multiple beneficiaries, the trustee may weigh the needs of each in deciding how much trust income to distribute or reinvest, when to make principal distributions, and who should receive them. The trust document often will include guidelines on such matters.
Gift-to-minors trust	For young children, contributions of up to $13,000 per year to this sort of trust will avoid gift taxes. A married couple can together set aside $26,000 each year for each child or grandchild, so in a few years a significant source of capital may be built up. Assets may be used for any purpose, including education funding, and will be counted as the child's assets for financial aid purposes. The assets of a gift-to-minors trust must be made fully available to the child when he or she reaches age 21. However, the child may be given the option of leaving the assets in further trust.
GST trust	The generation-skipping trust takes advantage of the exemption from the federal generation-skipping tax, a tax that otherwise may apply in addition to the gift or estate tax.

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How to keep the family business in the family

The American Family Business Institute, an advocate for small businesses, has long argued that the burden of death taxes (estate and inheritance taxes) impairs the ability of keeping family businesses going after the death of the founder. They note that 70% of family businesses do not survive to the second generation, and 90% fail to reach a third generation. A recent study by the American Family Business Foundation concluded that repealing the estate tax entirely would add $119 billion to GDP and increase the incomes of American workers by $79 billion. Another study, by the former director of the nonpartisan Congressional Budget Office, Douglas Holtz-Eakin, found that death tax repeal would create 1.5 million small business jobs and decrease the national unemployment rate by nearly one percent.

Although legislation to repeal the federal estate tax permanently has been introduced this year, few observers expect it to happen. Business owners are going to have to take action if they want to gain control over their death tax exposures. That's what the Wandry family did.

Gifts of partial interests

Joanne and Dean Wandry created a limited liability company (LLC) to facilitate giving gifts to their heirs. On January 1, 2004, each of them gave $261,000 worth of units in the LLC to each of their four children, as well as $11,000 worth of units to each of five grandchildren. At that time, the annual gift tax exclusion was $11,000, and the lifetime federal gift tax exemption was $1 million. Thus, they fully utilized these legal protections and owed no gift tax.

The exact number of LLC units (similar to shares of stock) covered by those dollar amounts was not determined at that time but was to be calculated by an independent third-party professional at a later time. Most importantly, the document executing the gifts also provided for an adjustment in the number of units in the event of an IRS audit.

When the $1,099,000 worth of gifts was reported on the federal gift tax return, the attached schedule described each child's interest as a 2.39% LLC interest and each grandchild's as a 0.101% interest. Upon audit, the IRS determined that the LLC was worth more than reported, so the 2.39% interest and the 0.101% interest were worth more as well. This was enough more to trigger a gift tax liability.

Careful lawyering

The Wandrys contended instead that the 2.39% and 0.101% fractions should be reduced until they matched the dollar amount of the intended gift. In an important Tax Court decision earlier this year, they won their point.

When stipulations have been attached to gifts that attempt to void or partially reverse a taxable gift in the event of an IRS audit, those stipulations have been held to be without effect for gift tax purposes. The Tax Court found that the improper "savings clauses" were not the same as the "formula clause" used by the Wandrys. A formula clause is permissible. The key difference is that no property is taken back with a formula clause. Although the value of each membership unit was unknown on the date of the gift, the value of a membership unit on any given date is a constant, and it is not changed by the revaluation of the firm as a whole upon audit.

The importance of the decision

This is the first time that the Tax Court has approved what estate planners call a "defined value" gift formula. No one knows for certain what the federal gift tax exemption will be in 2013, but current law calls for a reduction of more than 80%, to $1 million from the current $5.12 million. That has many estate planners recommending gifting to their wealthier clients, in order to lock in the higher exempt amount.

But with assets that are hard to value, it can be tricky to make a gift of so exact an amount. A defined-value clause may resolve this problem in appropriate circumstances. ☐

The IRS's 2012 "dirty dozen"

Each year, the IRS alerts the public to the 12 worst tax scams that have been brought to its attention. The list changes slightly from year to year, and there never seems to be a problem coming up with candidates.

Identity theft. This is the number one problem, as identity thieves have been known to file false tax returns in order to obtain fraudulent tax refunds. The first tip-off for the taxpayer may be a note from the IRS that more than one tax return has been filed. Reportedly, the IRS screening procedures in 2011 protected more than $1.4 billion from getting into the wrong hands.

Phishing. Scammers send e-mails that purport to be from the IRS, hoping that an unsuspecting recipient will open it or an attachment. This can lead to identity theft. The IRS never initiates contact via e-mail.

Return preparer fraud. An estimated 60% of taxpayers now find their returns so complicated that they have to pay a professional to help them file. Some tax return preparers are fraudsters. Bad signs include promises of larger than normal refund, failure to give payer a copy of the return, charging a percentage of the refund as a preparation fee.

Hiding income offshore. A major crackdown on foreign accounts has been accompanied by a voluntary disclosure program, to permit taxpayers with offshore accounts to resolve their tax liabilities. Some $3.4 billion was collected under that program in 2009, $1 billion so far from a second round conducted in 2011.

"Free money" from the IRS and tax scams involving Social Security.

False or inflated income and expenses. Interestingly, some taxpayers are now claiming income that they have not earned, in order to maximize their refundable credits. Some are inappropriately claiming the fuel credit that is available to farmers and others who use fuel for off-highway business purposes.

False 1099 refund claims. Contrary to the claims of some scam artists, the federal government does not maintain secret accounts for U.S. citizens that may be accessed by issuing 1099-OID forms.

Frivolous arguments. The argument that the income tax is unconstitutional is not going to work. The IRS maintains a list of frivolous arguments that will lead to additional penalties.

Falsely claiming zero wages.

Abuse of charitable organizations and deductions. Deductions for donations of non-cash assets is a problem area.

Disguised corporate ownership.

Misuse of trusts. This is the one that bothers us the most. Trusts are a legitimate, long-established wealth management tool. Some trusts have tax benefits; some do not. They are not means to create deductions for personal expenses. ☐

How NOT to structure an inheritance

Don't rely upon Rube Goldberg solutions. To be confident that your heirs will receive a permanent financial resource, rather than just a short-term windfall, use a time-tested strategy. Use a trust.

See us soon to learn more about the wealth-management benefits that a trust can deliver to your family.

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