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Financial Planning Strategies

A Financial Planning Update

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Mr. Kennedy's investment philosophy is the same that he has practiced over the last decade: securities markets are efficient and advisors primarily add value by coordinating the asset allocation for clients based upon risk tolerance, objectives, and time horizons. The firm has constructed 5 models for clients that vary in risk to meet the goals of each client. The firm primarily uses passive mutual funds in each model and uses select actively managed funds for bond, commodity, and real estate exposure. ITI uses several research resources, including many that were used over the last 20 years, to assist with the recommended asset allocation and the appropriate funds to utilize in each model.

Offset the Effects of Inherited Wealth with Incentives

For many affluent individuals, estate planning extends well beyond tax planning and involves very personal decisions about the distribution of future wealth. In more traditional estate plans, the **spendthrift trust** is used as a vehicle for distributing trust income, while limiting immediate access to trust principal.

A spendthrift trust can help provide a financial head start for minor children and protect adult heirs from certain creditors and limitations in financial judgment. However, such trusts may provide heirs with little incentive to expand their own professional, academic, or philanthropic horizons. Thus, affluent individuals who are particularly sensitive to the potential ramifications of "handing over" considerable wealth to heirs may choose to establish an *incentive-based* estate plan.

One of the cornerstones of an incentive-based estate plan is the **family incentive trust** (**FIT**). Like typical trusts associated with estate planning, a FIT helps trustees implement an affluent grantor's expectations about the uses of his or her estate. Similarly, a FIT can help ensure proper care and financial support if an heir falls on hard times or has special needs. However, a FIT is somewhat unique in that the general distribution of trust income is based on a series of predetermined "incentives."

Promoting Success and Reinforcing Values

The incentives outlined in a FIT are at the discretion of the grantor. Each incentive provides the grantor with the opportunity to encourage specific future behavior. For instance, the trust could have provisions that pay each heir $10,000 on acquiring a bachelor's degree, $25,000 for a master's degree, and $50,000 for a doctorate. A FIT can also be an ideal tool to reward family members who pursue and/or distinguish themselves in a career path of the grantor's choosing, such as the family business, music, the arts, research, or teaching. A FIT can reward younger heirs for academic success or community involvement. In addition, the trust can match certain levels of income for heirs who are younger than a specified age.

A FIT may also be an appropriate vehicle for education funding. Unlike a custodial account, which generally becomes the property of the child once he or she attains the age of majority (determined by state law), a FIT can dictate that some trust assets be used to

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Are Two Incomes Better than One?

The concept of the "traditional" American family, with one spouse who works and one who cares for the home, has changed over time in response to life's many challenges and opportunities. The dual income family, with husband and wife each managing separate careers and contributing to the financial success of the household, has become commonplace.

Today's families have a variety of financial commitments and expectations, and two incomes may often be required to meet the overall expenses of the family. Both spouses may wonder how they will save for their children's education, plan for their own retirement, and perhaps help their aging parents handle some of their financial burdens.

The Cost of Working

The rewards of dual income families include the opportunity for both husband and wife to pursue a career and to accumulate financial assets for the future. While many may have more disposable income to cover necessities, and even some luxuries, other expenses may take a considerable bite out of that second paycheck. Job-related expenses, such as additional transportation costs, multiple car payments with auto insurance; parking fees; workplace attire; and take-out coffees and meals, may increase significantly. In addition, couples with busy work schedules may need to hire domestic help in order to maintain the household.

Further, childcare may be necessary for both spouses working outside the home. Quality childcare is one of the largest expenses of the dual income family, ranking close behind housing, food, and taxes. When all of these additional expenses are factored into the family budget, it is easy to see how a second paycheck may not provide as much income as anticipated to help fund education and retirement goals.

Maintaining Balance

Another important consideration for dual income families is the possibility of losing income due to disability, downsizing, or death, which can seriously strain the family's finances. One way to address these unexpected events is to insure *both* wage earners with **life** and **disability income insurance**.

Besides financial concerns, there is a growing emphasis on quality of life issues as families seek balance between their professional and personal lives. Work alternatives, such as telecommuting or job-sharing, have emerged as possible ways to achieve this balance, often allowing for more flexibility in caring for children and/or aging parents. $

Stretching IRA Withdrawals

The primary concern of some traditional **Individual Retirement Account (IRA)** holders who are approaching the mandatory distribution age (April 1 of the year *after* the year they reach age 70½) may be stretching their account assets over their lifetime and that of their spouse. Maximizing tax deferral and/or passing these assets to their heirs may be of lesser importance. Others, however, who are fortunate enough to enjoy sufficient retirement income from other sources, may wish to extend the tax deferral as long as possible.

Regulation reform finalized in 2002 makes this task much easier. In response to Americans living longer, healthier lives, the Internal Revenue Service (IRS) increased the life expectancy figures on which **required minimum distributions (RMDs)** are based. As a result, RMD amounts have decreased, and IRA owners are now allowed to withdraw *less* than was necessary under the original distribution rules. For most, RMDs are calculated using a uniform table (**uniform lifetime table**), which assumes a **beneficiary** is fewer than ten years younger than the owner, regardless of the beneficiary's actual age. If the IRA owner has named his or her spouse as the sole beneficiary, and the spouse is ten or more years younger than the owner, a second

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Stretching IRA Withdrawals

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table (**joint life and last survivor expectancy table**) may be used to calculate the RMD.

Beneficiary Choices

Married individuals quite often name a spouse as the beneficiary of an IRA. If the IRA owner dies prior to, or after, the mandatory minimum withdrawal date, only a surviving spouse can choose to make an inherited IRA his or her own. This would postpone mandatory distributions until April 1 of the year after the year in which he or she reaches age 70½.

In contrast, a non-spousal beneficiary is more limited and must begin taking distributions from an inherited IRA by the end of the year following the year of the owner's death. With the legislative changes, however, the consequences of beneficiary choices are no longer dependent on whether the IRA owner died *before* or *after* starting the required withdrawals, simplifying planning decisions. Unlike the old rules, such distributions no longer must continue to be based on the owner's original life expectancy calculation, but may now be stretched out over the life expectancy of the beneficiary, significantly extending the potential benefits of tax deferral.

What's the Advantage?

These simplified rules should make it easier for some retirees to meet the minimum distribution requirements, thereby avoiding unnecessary penalties, while enabling the greatest possible buildup of their tax-deferred assets. However, IRA owners should be aware that any such buildup could potentially lead to higher estate taxes down the road. If you have an IRA and have reached (or are approaching) age 70½, it may be best to consult a qualified tax and financial professional for assistance with your particular circumstances. $

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help cover education costs. Thus, the trust—rather than a young, inexperienced adult—can maintain control of monies earmarked for education.

Another interesting use of a FIT is treating the trust principal as a "family bank." The FIT can offer low-interest-rate loans for start-up business ventures or the purchase of a primary residence. To minimize risk to the trust, a lending process similar to that of a traditional lending institution can be established.

Philanthropy creates another possibility for an incentive-based estate plan. Certainly, many affluent individuals consider philanthropic pursuits to be important endeavors. A FIT can be used to match the charitable contributions of a beneficiary. Also, the FIT's matching contribution can be arranged as a distribution to the beneficiary, who then contributes it to the charity. Thus, the beneficiary can reap the benefits of a charitable deduction for his or her contribution, as well as the FIT's matching contribution. As an alternative, any remaining trust income that has not been distributed through incentives may be used to make a charitable contribution. Such contributions can also be arranged to be made on behalf of trust beneficiaries.

Sometimes, inherited wealth can have a negative impact on the motivation of heirs. For instance, when some heirs receive a substantial inheritance, they may be content with a life of leisure. Thus, the reasoning behind incentive-based estate planning is fairly straightforward. Assets and income are distributed to assist heirs who are realizing career or academic goals and/or whose actions are consistent with the expectations of an affluent grantor. By adopting some of the principles of incentive-based estate planning, the affluent grantor can promote a family legacy of excellence and productivity for generations to come. $

Taking Annual Gifts to the Next Level

You've probably worked a lifetime to build an adequate nest egg, live in a comfortable home, and accumulate an array of other assets. You may also realize that your finances could create unfavorable estate tax consequences. Perhaps you already have the compulsory legal documents, such as wills, trusts, etc. in place, and know that giving away assets may help reduce the size of your taxable estate. But, even though many people make occasional gifts to their children or other family members, few actually take advantage of the benefits offered through a *regular gifting program*.

Gifting Made Simple

Current tax laws allow you to give away $15,000 ($30,000 if married) in 2019 to as many people as you wish *without* incurring any gift taxes. This **annual gift tax exclusion** can be an effective means for gradually passing wealth to future generations. In fact, systematically making such a gift can create a rather sizable long-term result.

Let's look at this scenario: Suppose 60-year-old Mark starts a gifting program for his newborn grandson, Todd. Each year, Mark makes a gift of $15,000. After 25 years, Todd will have accumulated $375,000, assuming 0% growth. In addition, suppose Debbie, Mark's wife, age 60, also chooses to make a $15,000 gift to Todd, bringing the total annual gift to $30,000. In this case, Todd will have accumulated $750,000 in 25 years (assuming 0% growth). In this win-win situation, the couple helps Todd accrue a nest egg, while, at the same time, lowering the value of their estate. This strategy may help Debbie and Mark minimize their estate tax liabilities.

One Step Beyond

Using the annual gift tax exclusion to fund a life insurance policy creates the potential to turn gifts into a substantial death benefit. Once again, suppose Mark (the donor) sets up an irrevocable life insurance trust (ILIT) for the benefit of Todd. The ILIT then purchases life insurance on Mark. Upon Mark's death, the life insurance death benefit proceeds are payable to the ILIT. Since the policy is owned by and payable to the ILIT, there are no transfer tax consequences to Mark's estate.

Life insurance may provide an ideal mechanism for leveraging annual gifts. In the short term, it offers an immediate death benefit that generally outweighs the total premium outlay (gifts). While over the long term, life insurance offers a unique opportunity to potentially leverage annual gifts into a significant benefit for selected beneficiaries. This can be achieved by taking advantage of the tax-deferred buildup of policy values, which in some cases may indirectly increase the life insurance policy's death benefit over time.

The use of a regular gifting program may be advantageous to individuals seeking to gradually reduce the size of their estates. In addition, it affords these individuals the opportunity to pass wealth to children, family members, and others with reduced tax consequences. For specific guidance, be sure to consult your qualified tax and legal professionals about your unique circumstances. $