

WILLMS, S.C.

LAW FIRM

TO: Clients and Friends of Willms, S.C.
FROM: Andrew J. Willms, JD., LLM.
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SUBJECT: Investing With Your Estate Plan

Introduction

Prudent investors know that a number of competing considerations need to be balanced when implementing a particular investment strategy as well as when deciding whether a particular investment should be added or removed from the investor's portfolio. These considerations include the investor's personal investment objectives, time horizon, risk tolerance and cash flow requirements, to name just a few. Unfortunately, even the most astute investors often fail to consider the impact their investment choices will have on their estate planning.

The purpose of this article is to encourage readers to keep in mind how their investment decisions will impact their estate planning. In 2001 your author began assisting a limited number of Willms, S.C.'s estate planning clients with their investments.¹ This experience has led to an increased appreciation for the importance of integrating an investor's estate plan with their investment decisions. Incorporating the two can greatly improve a portfolio's after tax rate of return.

Investment Objectives

Perhaps the most fundamental issue that must be considered when making an investment decision is what the investor's ultimate objectives are. For example, is the investor trying to create wealth that can be used for his/her support as well as the support of his/her family? If so, is the need for support immediate or more long-term, as in planning for

¹ Investment advice and asset management is provided to clients of Willms, S.C. by Andrew Willms through Estate Counselors, LLC, which is a registered investment advisor with the Securities Exchange Commission. Services provided by Estate Counselors, LLC do not constitute legal services and are not being provided by Willms, S.C. law firm. Communications between Estate Counselors, LLC and its clients are therefore not covered by the attorney-client privilege, and as a result may be discoverable by third parties. All such communications are, however, covered by Estate Counselor, LLC's privacy policy.

retirement? Is the focus even on trying to create wealth at all, or is it on wealth preservation, perhaps with the ultimate objective of passing wealth to loved ones or charity when the investor dies?

An investor's objectives will have a major impact on the investment approach that is best suited for him or her. For example, if the investor is hoping to create wealth by outperforming the market, then an active investment strategy might be appropriate. In simplest terms, active portfolio management involves trading stocks of individual companies. Investment decisions are driven by a desire to buy stocks of those companies the investor believes the rest of the market has undervalued and to sell those stocks the investor believes the market has overvalued. This management style also involves trying to time investment decisions in order to be more heavily invested when the market is expected to rise and to sell stock when it is believed that prices are on the verge of falling.

By comparison, a strategic asset allocation approach may be more appropriate for an investor who is more concerned with wealth preservation or creating a legacy. A strategic asset allocation approach involves investing in passively managed index funds and ETFs that are tied to the performance of a specific market index, such as the Standard & Poors (S&P) 500, the Dow Jones Industrial Average, the NASDAQ 100 or the Lehman Brothers Bond Fund Index. In other words, unlike active investors, an investor who adopts strategic asset allocation methodology does not try to outsmart the market. Instead, a strategically managed portfolio is diversified among ETFs and index funds that track different market segments (such as stocks issued by large, middle and small domestic companies, stocks of overseas companies, corporate and treasury bonds, real estate and cash).² This investment approach relies on academic research that suggests a portfolio maintaining consistent asset allocations in a variety of diverse asset classes can generate higher returns without a corresponding increase in risk.³

Account Ownership

An investor's estate plan can also impact the manner in which an investment account is owned. If the investor would like to avoid probate, but is not concerned about estate taxes (either because the size of his or her estate is less than the amount that can be given away

² Strategic asset allocation is the foundation of the investment approach utilized by Estate Counselors, LLC on behalf of its clients.

³ This methodology is commonly referred to as Modern Portfolio Theory, and was originally proposed in the 1950's by the Nobel Prize winner Professor Harry Markowitz of the University of New York.

estate tax free⁴ or because that part of the estate that would otherwise be subject to taxes is being given to charity) then it may be appropriate for the investment account to be held in the name of a revocable living trust rather than in the investor's individual name. Additional advantages of trust ownership are that the investor can dictate at what times and under what circumstances the investment account is to be made available to his heirs, and trust ownership can help protect the account from the heir's creditors in the event of a divorce, bankruptcy or lawsuit.

Managing Investments to Minimize Estate Taxes

Investors whose net worth is sufficient to subject their estates to estate taxes may want to structure their investments so as to limit the amount that would otherwise be subject to estate taxation. While a thorough discussion of this topic is beyond the scope of this article, the general idea is to structure and manage the investment portfolio to accomplish one or both of the following:

1. Utilize strategies permitted by the Internal Revenue Code to shelter future growth in the value of the investment portfolio from estate taxes by shifting that growth to younger members of the investor's family.
2. Take maximum advantage of the estate tax deductions, exemptions and credits provided for by the Internal Revenue Code.

Valuation discounts, grantor retained annuity trusts, family partnerships, installment sales and charitable trusts are just a few examples of the planning techniques that can be used to legitimately minimize estate taxes. You can learn more about these strategies at www.willmslaw.com.

Managing Investments to Minimize Income Taxes

Managing capital gain taxes is an important component to a successful investment strategy. Under current law, property that is includable in a deceased person's estate for estate tax purposes receives a basis adjustment for income tax purposes even if the decedent's estate

⁴ All U.S. citizens are entitled to a "federal gift tax exemption" which shelters lifetime gifts in excess of the annual exclusion from the federal gift tax. The exemption amount will shelter up to \$5,000,000 in gifts that exceed the annual exclusion from the federal gift tax. However, in 2013, both the federal estate tax exemption and the federal gift tax exemption are scheduled to be reduced to \$1,000,000 unless the tax laws are modified between now and then.

is not large enough to trigger an estate tax. This adjustment results in an heir's basis for federal income tax purposes being either "stepped up" or "stepped down" to the property's fair market value at the date of the decedent's death. For example, if a person's estate includes property that at the time of death had an income tax basis of \$100,000 and a fair market value of \$500,000, the person who inherits that property would receive a "stepped-up" basis of \$500,000. As a result, if the recipient sells the property for \$500,000, capital gain taxes are not triggered by the sale, because the difference between the \$500,000 sales price and \$500,000 tax basis is \$0.⁵

The possibility of receiving a step up or step down in basis at death is an important issue that needs to be carefully considered when deciding whether to sell securities with built in capital gains or losses. Capital gain considerations also need to be considered when making lifetime gifts because property received by gift has a "carry-over" basis in the hands of the recipient. This means the basis of property received by gift is equal to the income tax basis that the donor had in the property at the time of the gift. In other words, if the same property mentioned in the earlier example were given away during lifetime, the donor's tax basis of \$100,000 is carried over to the donee. Accordingly, if the recipient of the gift sells the property for \$500,000, then \$400,000 (the difference between the \$500,000 sales price and \$100,000 basis) is taxable to the donee as capital gain. As a result, it may be more advantageous to use cash or high basis securities when making lifetime gifts.

Lastly, it is also important for investors to keep capital gain taxes in mind when making gifts to charities. If a stock which has appreciated in value is gifted to charity, the donor will be able to deduct the value of the stock at the time of the gift for income tax purposes, but does not have to recognize the built in capital gain in income.

Conclusion

As the foregoing discussion illustrates, coordinating an investor's investment activities with the investor's estate planning can benefit both the investor as well as the beneficiaries of his or her estate. Please let us know if we can assist you with this type of planning.

End of Memo

⁵ An exception to the basis adjustment rules applies with regard to "income in respect of a decedent" (or "IRD") which is earned income that has not yet been taxed (i.e., retirement accounts, IRAs, annuities, deferred compensation, etc.). The tax basis of IRD property is not adjusted when the owner dies.