Some (Usually) Misguided Planning Strategies

In my 20+ years advising families of wealth, I have noticed some common financial and estate planning strategies that often create problems over time. These strategies (or lack thereof) are often undertaken with the best of intentions but repeatedly create problems that result in the negatives of the strategies outweighing the positives. Note, however, that all families are unique and circumstances vary,so the below list is intended to generate thought and discussion as opposed to being a set of universal truths.

1. Waiting (and Waiting and Waiting) to do Planning

The musician Prince died at the age of 57 with no will or other estate plan. While this was shocking to many people, especially given his estimated$300 million net worth, it is not uncommon for wealthy families to have under-planned, resulting in missed opportunities to direct assets as they wish and reduce the impact of taxes. Effective estate planning typically takes time– years, decades, or in some cases, generations. For families of wealth, it is imperative that estate planning is undertaken early and often for the family to see the resulting benefits.

2. Doing Planning that is Too Small in Scope to Move the Needle

For individuals with substantial estates it is often necessary to undertake major estate planning transactions to materially reduce estate tax exposure. We have seen a number of families engage in some very effective planning techniques, but do so with relatively small transaction sizes, resulting in them still paying quite large estate tax bills.

3. Not Doing Estate Planning that is “Risky” When the Status Quo is Worse Than the Downside Risk

A useful exercise is to prepare an analysis of what your projected estate tax liability will be at your death,and how that estate tax liability will be funded. Time and time again we’ve seen a client in a situation where they owed WAY more estate tax than they were comfortable with and/or were stuck with some serious liquidity issues in funding that estate tax bill. Yet, even in these dire estate tax situations, the client or attorney is unwilling to consider anything other than very low-risk estate planning strategies that are unlikely to have a big effect on estate tax liability. At this point,it is useful to look at the downsides of the so-called “risky” planning – if the downside of the planning not working is no worse than the (already bad)status quo, then it may make sense to consider undertaking the risky planning.

4. Not Taking Into Account Income Tax Aspects of Estate Planning

A number of years ago, the top estate tax rate was 55%, and the top federal long-term capital gains rate was 15%. With such a large differential,choosing to save estate tax over income tax was usually a no-brainer. Now the top estate tax rate is 40%, and the federal capital gains rate is 20% (plus 3.8% of “Obamacare tax”). Add in state taxes for those individuals living in states with a state income tax and the long-term capital gains rate is often over 30%. As such, any planning that only saves the estate tax rate, but results in lost step-up in in basis for income tax purposes is no-longer a no-brainer. This is especially true if the benefits of the estate planning rely on time to work – if the step-up is lost via the planning transaction on day one, but the estate tax benefit is only realized after many years, death shortly after the planning could leave the family in a worse situation.

5. Requiring Assets to be Distributed Out at a Particular Age

Irrevocable trusts can provide estate tax benefits to the extent they are Generation-Skipping Transfer Tax exempt and can provide for multiple generations without tax. Even trusts that provide no estate tax benefit can provide other benefits such as asset protection for the beneficiary(ies) from creditors, including ex-spouses. As such, it is usually advisable to create lifetime trusts for beneficiaries rather than requiring distributions out of trust to beneficiaries at various ages. A better route is to have the beneficiary become a co-trustee or sole trustee of the trust at the ages it is desired that the beneficiary have control of the assets.

6. Honoring Family Members by Naming Them as Trustee or Executor When They Are Not Qualified

A common adage is that the two happiest days in a boat owner’s life are the day that he buys his boat and the day the he sells it. A similar perspective also applies to being named as a fiduciary – it’s a great honor to be named and a huge relief when the position is over. A trustee’s work is difficult, technical, and time-consuming. It requires knowledge of trust law, distribution terms, income tax,estate tax, gift tax, generation-skipping transfer taxes, investments and entity administration. Only family members that are qualified to be trustee (and qualified to choose and oversee competent to assist) should be named to fiduciary positions. A desire to honor a family member with a fiduciary position or to avoid hurt feelings should not be the driving factor in choosing trustees.

7. Naming One Child as Trustee for His Sibling(s)

While there may be one child with a greater set of skills than the others, when it comes to acting as trustee, it is almost always a strain on the relationship to have one sibling act as trustee for another. Proceed with care. If you have a child who should not act as his own fiduciary, a course that puts less strain on the sibling relationship is to name an independent third party (i.e. another non-sibling individual or a trust company) as trustee.

8. Naming All the Children as Co-Trustees

Some trust grantors have difficulty in choosing which of their children to name as executor or trustee and ultimately name all of them (we've seen as many as six). The addition of each additional trustee slows decision making, increases the administrative burden of having documents executed, and increases the chance for conflict among trustees or executors.

9. Dumping a Great Amount of Assets, Responsibility, Etc. on Descendants Without Advance Education or Including Them in Planning

Managing a great amount of wealth can be similar to running a small to mid-sized business. Descendants named as successor trustee require preparation to be stewards of the family wealth through education and hands-on,real life learning with smaller entities and/or control of their own monies. Learning financial responsibility and appropriate investing takes time and experience.

10. Leaving Real Property as Tenants In Common (i.e. Jointly)

Joint ownership of real estate can create severe strains on familial relationships – we've seen it time and again. Tenants in common ownership of real estate requires unanimity for any decisions. If decisions cannot be made because siblings disagree, one can force a sale by bringing a partition action in court– a process that would stress a relationship even further. A more ideal route is to have real estate owned by an LLC, and then leave interests in the LLC to the family members. This allows for customized governance provisions for the property to reduce the strains associated with requiring unanimous votes.

11. Creating an Investment Partnership and Forcing Kids to Invest Together

A common desire within families is for younger generations to have close, positive relationships, and to spend time together (all positives). In furtherance of this goal, parents sometimes leave assets jointly in a partnership that the children are meant to manage together. While fostering closeness among one's children or other descendants is great goal, forcing children to make investment and distribution decisions together often backfires. Siblings and cousins often have differing investment goals and spending needs. Additionally,they often have different aptitudes with respect to investing.

A better route is to leave each child his own assets (in trust) but allow the children to choose to invest together in a partnership if they wish.

12. Naming Children as Directors of a Family Foundation So They Can Work Together and Be Closer (Where Children Haven't Expressed a Passion for Working Together to Make Charitable Gifts)

Giving away large sums to charity is a difficult job to accomplish effectively. Many wealthy individuals struggle to do so during their lifetimes, yet they fund large foundations at their deaths hoping their descendants will enjoy giving the money to charity. If children have expressed a passion for spending time and effort giving assets to charity, such a plan may be a good one. For children who have not adopted charitable giving as a passion, it is likely misguided to saddle them with running a large foundation. A better route is to seek the involvement of descendants during the donor's lifetime to gauge their interest, engagement, and willingness to devote time to such an endeavor.

13. Use of 529 Plans for Families with Multigenerational Wealth

Sections 529 Plans are state sponsored plans that allow the tax-free accumulation and investment of wealth for the purpose of paying for college. Use of 529 plans to fund college expenses makes a great deal of sense for most families given the income tax advantages. However, for families of great wealth, it is usually not advisable to use 529 Plans. Here's why: contributions to 529 Plans use up the donor's annual gift tax exclusion. Yet payment of a child's college expenses is not considered a taxable gift by the parent because such expenses are considered an obligation of support. A grandparent's payment of grandchild's college tuition directly to the educational institution is not considered a gift because of the special exclusion provided by the tax code. Therefore, from a transfer tax perspective,contributions to a 529 Plan waste the donor's annual exclusion, which instead could be used to fund a trust for descendants that can pay for other types of expenses that would a be a gift, such as buying a house or supplementing the beneficiary's lifestyle. And, the donor can still pay college tuition directly when the time comes, effectively getting a two-for-one deal that year for family members.