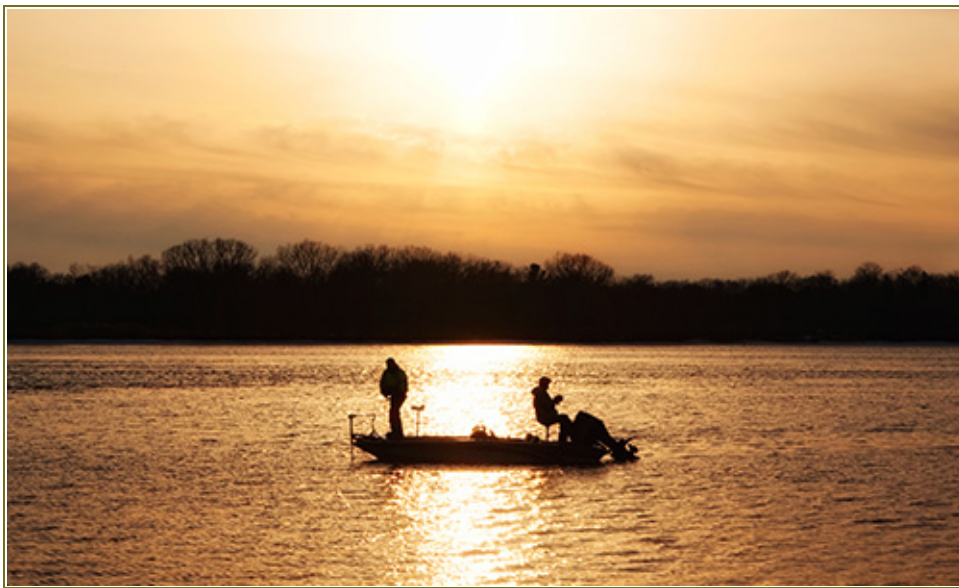




Understanding the Hidden Risks of Life Insurance: Due Diligence for Policy Holders and Fiduciaries



Life insurance is often a critically important part of an estate plan.

Immediate cash needs at death range from general living expenses to buying out a business partner or providing funds to pay estate taxes. But imagine opening a letter one day from your insurance company to find that your equity based life insurance policy may lapse due to lack of funding. Despite thousands of dollars in premiums dutifully paid over many years, market conditions may have quietly eroded the equity value of your policy. Over the past few years, universal and equity based life insurance policy owners have found themselves asking, “How did this

happen?" and "How could I have avoided this?"

The answer to the first question is fairly straightforward. Universal life insurance is still a relatively young product. It arrived in the marketplace in the late 1970s and saw explosive growth in popularity throughout the high interest rate era of the 1980s. Three decades and two recessions later, we find that the projections and assumptions originally used to illustrate the economics of the policy were not borne out in reality.

The low interest, low return environment that we have experienced over the past decade has resulted in the owners of universal life policies receiving considerably less interest on the cash portion of their policy as compared to the higher interest rates that were available at the time of purchase and were used in projections and illustrations. Meanwhile, the policy charges that were easily handled at the higher projected interest rates are now adversely impacting the originally projected policy cash values. This will result in less than expected cash values down the road, potentially reduced death benefits and/or in the worst case, policies lapsing years earlier than originally projected. The owner faces the difficult decision of anteing up additional money to save the policy, or losing their coverage and the years of premiums they have already paid. Even more problematic are the policies that have eroded to near worthlessness under the care of a well-meaning, but uninformed trustee.

With regard to the second question, determining whether there might be a looming problem or opportunity requires some work, but may well be worthwhile for owners and trustees alike. Here are some suggested steps to getting at the issue.

First, locate the most recent premium statement, the original contract, and the illustration provided when the policy was purchased. You'll want to review the contract for the death benefit, premium amount, duration, and type of policy such as term, universal or whole life. Next, ask your broker or agent for an "in-force ledger" that will help you determine how long the policy will last, and what future premiums might be required to maintain the policy. And, of course, reevaluate the purpose of the life insurance to determine if there is still a need for the coverage--even if the need has changed since the time of purchase.

If you are in good health, you may actually find new policies charging lower premiums for the same coverage. This is because most insurance carriers have been able to improve the prices of their newer policies by reducing the cost of insurance charges due to better than projected mortality experience (insureds living longer than expected). On the other hand, if your health has declined, you may be able to reduce or skip the next premium. Why? Most universal life policies are sold with a life expectancy past age 100 even though most people will never live that long. There may be enough built up equity value in your portfolio to carry the policy without fulfilling all of the originally scheduled premium payments. A recent review on a 78-year-old man who had \$9 million of coverage between three universal life policies (that his family thought were no longer affordable at the projected higher premium due to low interest rates) resulted in a savings of over \$100,000 per year simply by focusing on his life expectancy and not the impact of low interest crediting rate!

Finally, if you are the trustee of a life insurance trust, you have a fiduciary responsibility to monitor the policy, even if you are an unsuspecting family member who is not a financial professional. Just paying the premiums and issuing the Crummey notices is only part of the trustee's responsibility. Protecting the assets of the trust and protecting the

beneficiaries needs to be addressed by performing periodic due diligence ranging from reviewing the company's current credit-worthiness to following the steps above.

So perhaps consider a life insurance "physical" as part of your year-end tax and financial planning or add it to the long list of New Year resolutions! Your insurance advisor should be able to help you understand the financial "fitness" of your policy or your WTAS advisor can help coordinate a review with a qualified insurance professional.

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Tax Quirks That Make You Go Huh?



Ever heard the maxim, “always expect the unexpected”? We have all experienced its truth in the “real world.” Similarly, the tax law has no lack of oddities or quirks that can leave even tax professionals uttering “huh?”

Following are some of the more common oddities of the tax law that effect more taxpayers than you might think.

The Marriage Penalty – “Oxymoron” or “Truism”?

It would seem inexplicable that the entering into the institution of marriage should bring about a tax penalty.

However, the way the tax brackets are arranged for different categories of filers, it is very possible for two unmarried individuals to pay less tax on a combined basis than if they were married.

For example, two unmarried individuals filing as single, earning \$183,250 each, would pay tax at a marginal tax rate of 28% for a total of \$89,206 (\$44,603 each). However, if those same individuals were married and filed a joint return, their combined income would yield a tax liability of \$97,257. This translates into a marginal tax rate of 33% and a tax increase of \$8,051. "Huh?" A marriage penalty indeed!

Incentive Stock Options – “Carrot” or “Stick”?

Congratulations! The company for which you worked for the past three years just went public at \$100 per share and the incentive stock options ("ISOs") you were granted in year one are worth a fortune. You know that the primary benefit of an ISO is that long-term capital gains rates can be utilized if certain holding period requirements are met. The stock needs to be held for at least one year after exercise and at least two years from the option grant date. The 100,000 options you were granted have a \$0.10 exercise price and are now worth \$10 million.

While jumping for joy, you call up the company and inform them that you want to immediately exercise all of your options. You pay the company \$10,000 (100,000 options * \$0.10 exercise price) and the company puts 100,000 shares into your brokerage account. On your way to the IPO party, you call your accountant to tell her about your newfound wealth. However, she proceeds to inform you that you now owe about \$2.8 million in federal taxes even though you did not sell a single share. "Huh?"

What you did not know is that ISOs, although when exercised, are not subject to regular tax, are subject to Alternative Minimum Tax ("AMT"), at a rate of 28%, on the difference between the exercise price and the fair market value at the time of exercise. Of course, you could sell enough shares to pay the tax. However, then the taxable income on the shares sold will be taxed at ordinary instead of capital gains rates. Now let's add some more salt to the wound.

The next morning you wake up to headlines stating that your company is being investigated for fraud. The stock drops to \$0.01. This is a disaster! You still owe \$2.8 million in taxes from the option exercise and even if it was possible to sell stock, you would not generate sufficient cash to pay the tax bill. Further, with the expiration of the refundable alternative minimum tax credit in 2012, any tax benefit attributable to the AMT taxes paid can only be applied to prospectively generated income. This means that unless you have significant income in the future, you may never recoup all of the taxes paid for the now worthless stock.

The moral of the story is never exercise ISOs without discussing it with a qualified tax professional.

Statutory Residency – When is a “Pied-à-Terre” a huge pain?

Most people consider themselves a resident of only one state but this is not necessarily the state they are employed in. If your home is located a distance from your place of employment, it would not be uncommon for you to purchase or rent an apartment that is closer to your employment but not in the state in which you reside. You now exist in a twilight zone because it is very possible that you could be considered a statutory resident of the state you

are employed in as well as the state you call home. (See "[Home is Where The Heart Is.](#)")

New York State (NYS) and New York City (NYC) would consider your "Pied-à-Terre" a "permanent place of abode" for statutory residency purposes. If you spend more than 183 days in NYC (any portion of a day, not necessarily a work day), you would be deemed a NYS and NYC statutory resident subject to tax on ALL of your income (including interest, dividends, capital gains, etc.) not just the portion you earned in NY. The issue here is that your home state will also tax all of your income but they will only allow you a credit for taxes paid to NY that relate to your NY earned income. No credit would be allowed for your unearned investment income (e.g., interest, dividend, etc.) and this would be subject to a hefty double tax.

Of course, you might wonder how NY would even know that you have an apartment in NY. The answer is very simple. If you file a NY Non Resident return to report your NY earnings there is a question on page 1 of the return that you must answer. It asks, "Did you or your spouse maintain living quarters in NY?" Once you check this box "Yes" your chances of being audited by NY jump significantly. Once under audit, the burden is on you to prove where you were on every single day including holidays and weekends. If you cannot prove where you were on a specific day, NY will count this as an NY day. "Huh?"

Maintaining detailed documentation of your whereabouts is critical. If you choose to take on this mission "almost" impossible, consult with a tax advisor who is experienced with residency issues.

Expatriation – "You can leave but it will cost you!"

The United States taxes its citizens and long-term green card holders on their world-wide income regardless of where they live. The only way out of the U.S. tax regime is to move abroad and give up your citizenship/green card. However, before you get all happy, you should know that the U.S. will charge an exit tax on your assets' unrealized gain at the time of expatriation. "Huh?"

This exit tax is effectively a mark-to-market regime that takes all of your assets and deems them as being sold on the day you leave the country. Of course, expatriating is not as simple as this. Therefore, before you pack your bags, consult a qualified tax advisor.

Conclusion

The U.S. as well as the States' tax law is full of items that will make you say "huh?" The items listed above are just a small sampling illustrating the importance of having a qualified tax advisor as part of your professional advisory team.

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Home is Where the Heart is....or is it? Establishing Residency in a New State



With the hassle of planning an out-of-state move, taxpayers often overlook an important aspect—changing residency for state tax purposes.

Incorrectly or incompletely transferring residency can result in an audit or filing requirement in the taxpayer's former resident state. Properly establishing residence in a new state helps a taxpayer avoid these issues after moving.

States may tax the worldwide income of their residents. Generally, states determine residency by:

1. statute (a permanent abode coupled with a minimum number of state days for any purpose); or
2. domicile, a legal concept.

Statutory residency is an objective standard, and its determination can be relatively mechanical. For purposes of this article, we focus on domiciliary residency.

Domicile focuses on the individual's intent to make a permanent home, a subjective standard. Confusion arises when a taxpayer is considered a legal domiciliary of multiple states. In situations where a taxpayer moves from a high- to a low- or no-income tax jurisdiction, a former resident state may attempt to claim the taxpayer as a resident. A taxpayer often discovers, to his/her tax detriment, that once domicile is established in a state, changing it is difficult.

To establish domicile in a new state, a taxpayer must show he/she physically moved out-of-state, maintains a place of abode in a new state, and intends to remain in the new state permanently or indefinitely. States use a facts and circumstances test composed of several factors to determine whether a taxpayer is a resident domiciliary. None of these factors are determinative in and of themselves; instead, the focus is on a comparison and a weighting of the level and types of activities engaged in by a taxpayer in the two jurisdictions in question.

States give primary importance to five factors when evaluating domicile: home, active business involvement, time, items "near and dear," and family connections. States will consider other factors if the primary factors do not resolve the issue.

Primary Factors

The location of a taxpayer's "home" is harder to determine when a taxpayer retains the old residence as a vacation home or hotel-substitute after moving to a new state. In these situations, states compare the original residence with the new residence to determine domicile. Whether the homes are owned or rented is not important. Aspects of the home that are important in this comparison are size, value, and nature of use. Size and value, especially, must be viewed in the context of the geographic area where the residences are located.

Domicile is more likely to remain with the original state if a taxpayer continues employment or active participation in a business located in the original state. A taxpayer may claim active participation in a business on his/her Federal income tax return in order to avoid passive activity loss limitations. However, if the active business is located in a taxpayer's former resident state, a state could argue the taxpayer never changed domicile. This can be mitigated if a taxpayer can show that most or all of the taxpayer's business efforts are performed in the new state. Passive investment in a business, though, located in a former resident state does not support an argument for or against domicile.

"Time" is a quantitative analysis of where a taxpayer spends time during the tax year. If the statutory threshold mentioned above is not met, "time" requires a subjective analysis. A comparison is made between where a taxpayer

is required to spend time (i.e., work) and where a taxpayer chooses to spend time (i.e., vacation, leisure activities).

Items "near and dear" are those items with sentimental value, including book and art collections, family heirlooms, pets, and other personal items. Moving these items to the new state strengthens a taxpayer's claim of domicile in the new state. All the facts and circumstances must be considered. Thus, a taxpayer should account for "near and dear" items' sentimental and monetary values to the extent these items will be split amongst different abodes.

The final primary factor, family connections, focuses on the location of a taxpayer, a taxpayer's spouse or partner, and a taxpayer's minor children. In some cases, the definition of family expands to include adult children or elderly parents.

Cumulatively, a significant adjustment in a taxpayer's lifestyle clearly evidences domicile change. For example, spending an additional month in Florida every year is not as dispositive as moving to Florida with family heirlooms, buying a bigger home, and giving up active participation in a business in the former resident state.

Other Factors

Besides the primary factors discussed above, other factors that support domicile in a state include:

- Address where bank statements and bills are received;
- Location of safe deposit boxes;
- Location of vehicle registrations;
- Location of voter registration and participation in local elections;
- Public library cards;
- Social and athletic club memberships;
- Updating will to new state; and
- Use of professional services.

In their residency analyses, most states do not include charitable or political activities/contributions to organizations located in the taxpayer's former resident state.

Given the stagnation of the economy, and states' insatiable desire to grow their tax revenue bases, simply moving to another state may not change residency for state tax purposes. Without proper planning, a taxpayer may have two states claiming residency. However, with knowledge of the above factors, along with appropriate actions and detailed records, the residency transition can be painless.

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Transitioning to a Rising Rate Environment



In the five years since the Credit Crisis and Housing Bubble, the United States economy has been marred with negative or substandard economic growth.

How We Got Here

Job creation and economic activity have been best described as anemic, resulting in unprecedented monetary policies initiated by the U.S. Federal Reserve and the world's largest central banks. These policies have been titled "quantitative easing" and have succeeded in reducing interest rates to historically low levels.

Since 2008, markets have watched Chairman of the Federal Reserve Ben Bernanke's every move as the Federal Reserve instituted various forms of quantitative easing in hopes of stimulating economic growth. Quantitative easing is designed to increase the money supply by replacing Treasuries and other government agency securities with printed currency, thus providing financial institutions with capital in an effort to promote lending and liquidity. This type of quantitative easing also lowers interest rates by artificially subsidizing demand for bonds thereby decreasing market borrowing rates. In theory, these lower interest rates will motivate different types of common borrowing such as refinancing, car purchases, home buying, etc.

In the first eight months of 2013, we saw interest rates on the 10-year Treasury note slowly rise as the markets expected the Federal Reserve to begin reducing its bond-buying program. Market speculation about the timing of the tapering of quantitative easing led to periods of increased volatility. However, on September 18, Bernanke announced that the Federal Reserve would not slow the pace of its bond purchases and that quantitative easing would remain in effect until unemployment and the economy showed additional improvement. Rates then quickly retreated to 2.5% in response.

Nevertheless, with more economic data reports trending positive, rates have again begun to slowly ascend higher as the markets once again begin to embrace the eventual tapering of the Federal Reserve's bond-buying program. Even with what seems to be a gradual increase from say 2.5% to 4% (where many economists expect the 10-year Treasury note to rise), bond portfolios could see a drastic decline in principal value if not properly diversified.

The Federal Funds rate (an overnight lending rate for depository institutions that serves as a benchmark rate which generally drives the level of all other interest rates) is currently between 0% and 0.25%, a historically low level. Despite the inevitable tapering of quantitative easing, short-term interest rates are anchored by the Federal Reserve's current policy initiatives. Since rates are still low, now may be an ideal time for investors to re-evaluate the role fixed income will serve in their portfolio and explore strategies to take advantage of the transition to a rising rate environment.

Strategies to Position Your Portfolio

An effective strategy could be to allocate the majority of a fixed income portfolio to bonds with a shorter duration by investing towards the short end of the yield curve. In the current low-rate environment, shorter-term maturity bonds which have lower yields but less price sensitivity to changes in interest rates can provide stability in a portfolio. When the Federal Reserve begins its tapering of quantitative easing and interest rates begin to rise, those investors with longer duration fixed income positions could see their bond values deteriorate, as bond prices move inversely with interest rates. Investing in fixed income securities with maturities of less than five years will protect against rising interest rates as shorter-term bonds are less sensitive to movements in interest rates. In addition, as rates begin to increase, these shorter term bonds will mature or can be sold to reinvest in newer, higher-coupon bonds.

Since volatility is likely to remain in the markets for the foreseeable future, floating-rate debt securities can be used to hedge against some of the interest-rate risk. Because the interest rate on these securities is adjusted on a 30, 60 or 90-day interval and is determined by a floating reference rate, usually LIBOR (London Interbank Offering Rate)

or the Federal Funds rate plus an additional spread based on the borrower's credit, their yields will automatically remain aligned with market rates.

Higher yield bonds, with their higher coupon rates and interest payments (to compensate investors for the increased risk) can help to shield investors from lower bond prices due to rising rates. Rising interest rates generally occur during an improving economy, and since the Federal Reserve has indicated that interest rates would remain at current levels until the economy improves, we should anticipate that any economic improvement would lead to better performance of these bonds since improved credit risk should support their prices. However, as we saw in 2008, investors interested in this asset class must pay particular attention, since a decline in credit markets could lead to significant losses, regardless of the higher stated interest rates.

The use of proficient separate account managers as opposed to accessing fixed income markets through mutual funds can provide an additional benefit in uncertain markets. When markets are in turmoil, mutual funds may be forced to sell their highest quality, most liquid securities to meet redemption requests, resulting in poor execution. By using separately managed accounts, investors will not suffer the effects of someone else's redemption requests. Furthermore, the potential credit risk as well as the re-investment risk can be mitigated. Barring a default or call, bonds held in a separate account can be held to maturity, ensuring the principal value for the investor.

In conclusion, some of the strategies to consider implementing in one's fixed income portfolio in times like the present include shortening duration, yield curve positioning, an emphasis on higher yield bonds and utilizing separate account managers. Risk and volatility are as prominent in fixed income as they have ever been, but these approaches could provide diversification benefits and increased yield to portfolios in this challenging environment. A careful review of your specific goals matched with the objective advice of a trusted advisor should help create a more appropriate portfolio suited for your specific objectives.

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