1. INTRODUCTION

This reading focuses on three investment considerations:

1. **Taxes** (impact on wealth accumulation).
2. **Concentrated positions** (in private or public assets).
3. **Preserving wealth through generations** (tools and techniques)

The objective of private wealth managers is to maximize the after-tax wealth of a client consistent with his/her risk tolerance and portfolio constraints.

Taxes, concentrated portfolio positions, and costs of transferring property to heirs (particularly for high-net-worth individuals) tend to have a substantial impact on the net performance of the portfolio.

2. GENERAL PRINCIPLES OF TAXATION: COMPONENTS OF RETURN AND TAX STATUS OF THE ACCOUNT

Three key elements of investment taxation, in managing private wealth assets are:

1. Taxation of the components of return
2. Tax status of the account
3. Tax Jurisdiction (that applies to the investor and/or account)

2.1 Taxation of the Components of Return

Some common types of taxes, widely recognized across jurisdictions are as follows:

1. **Income Tax** – tax rates applied on income, including salaries, interest, dividends, etc. These taxes are applied (based on levels of income) to individuals, corporations, and other types of legal entities.
2. **Gains Tax** – Tax rates applied on capital gains. Capital gains are realized profits from the sale of the assets (financial or non-financial).
3. **Wealth or Property Tax** – Taxes charged on holdings of certain types of property (e.g., real estate, financial assets).
4. **Stamp Duties** – It is the tax government imposes on the purchase of shares or real estate. Usually, foreign investors pay higher rates than domestic investors.
5. **Wealth transfer** – A tax imposed when assets are transferred from one owner to another. For example, tax on gifts made during one's lifetime, bequests upon one's death, etc. Taxes are may be imposed on the transferor or the recipient

In short, investors pay taxes on what they:

- earn (income tax and gains tax)
- own (wealth or property tax))
- buy (stamp duty tax)
- transfer (gifts & estate tax))

2.1.1) Interest, Dividends, and Withholding Taxes

In some jurisdictions, interest income from government bonds is exempt or is taxed at a favorable (lower) rate.

Double taxation: When corporate earnings are taxed twice i.e., once at the corporate level and then again at the shareholder level the earnings are distributed to shareholders as dividends.

Withholding Taxation: Taxes imposed in the country where income is earned without regard for offsetting expenses or losses available to the taxpayer from other investment activities.

2.1.2) Capital Gains Taxes

Tax basis: cost of an asset or amount paid to acquire the asset.

Capital gain/loss = selling price (net of commissions & trading costs) – tax basis

- Realized capital gain: profit booked when the asset is sold
- Unrealized capital gain: change in the value of the asset currently held in the portfolio.
- The long-term capital gains rate is lower than the short-term capital gains rate. Therefore, long-term investors have tax-incentive.

Some jurisdictions distinguish between investment gains and trading gains as lower tax rates are applied on investment gains.

2.1.3) Real Estate Taxes

Real-estate investments are subject to a wide range of tax preferences. Typically, real estate tax liability is

determined based on net income from real estate investment.
Tax liability = Net Income x Tax rate

where, Net Income = Gross Income– Expenses (maintenance, interest, depreciation).

Since both interest and depreciation expenses are usually tax-deductible, this reduces the investor's income tax liability. Therefore, investors prefer to finance the real estate purchase instead of purchasing at full price.

2.2 The Status of the Account

The impact of taxes depends on the type of investment account in which assets are held. Investment accounts can be classified into the following three categories:

1. **Taxable accounts:** In taxable accounts, investments are made on an ***after-tax basis*** and returns are taxed by applying normal tax rules.
2. **Tax-Deferred accounts (TDAs):** In tax-deferred accounts:
   - Investment and Contributions are made on a pretax basis and
   - The investment returns grow tax-free until the time of withdrawal at which time withdrawals are taxed at ordinary rates.
3. **Tax-exempt accounts:** In tax-exempt accounts:
   - No taxes are assessed during investment, contribution, or withdrawals.
   - Investment returns grow tax-free, and withdrawal of investment returns in the future is NOT subject to taxation

Practice: Example 1 CFA Institute's Curriculum, Reading 22.

3. THE JURISDICTION THAT APPLIES TO THE INVESTOR

Tax systems:

- are the rules that specify how and when different types of income are taxed.
- vary among countries depending on the funding needs and objectives of the governments.

Hence, it is necessary for investment advisors to understand the impact of different tax systems on portfolio returns.

Three broad categories of tax systems are:

1. **Tax havens** - country or independent zone with no or very low tax rates for foreign investors. E.g., the Cayman Islands, the Bahamas, the British Virgin Islands.
2. **Territorial tax systems** – only locally-sourced income is taxed. E.g., Hong Kong, Philippines, Singapore.
3. **Worldwide tax systems** – all income is taxed regardless of its source. E.g., Germany, Canada, Japan, India.

Note: The Worldwide tax system may create a double-taxation problem in which two countries may claim to have taxing authority over the same income or assets.

The issue is usually resolved through some form of a tax treaty between countries or the home country may offer tax credit.

Practice: Example 2 & 3 CFA Institute's Curriculum, Reading 22.

4. MEASURING TAX EFFICIENCY WITH AFTER-TAX RETURNS

4.1 Tax Efficiency of Various Asset Classes and Investment Strategies

Tax-Efficient strategy: a strategy that gives up very little return in the form of taxes.

Equity strategies are usually more tax-efficient than other assets (derivatives, taxable fixed income, and real estates) because:

- dividends are taxed at favorable rates.
- capital gains are taxed less than ordinary income

- flexibility on the timings of selling decisions gives managers control over the tax burden.

Tax rules for alternative investment strategies are difficult to understand because:

- different types of alternative asset classes usually have their own tax rules.
- alternative investment strategies usually employ leverage, short-sales, convertible debt, complex derivative positions, etc.

Within an asset class, the tax efficiency of a portfolio depends on the investment style and trading behavior of investors. For example, high-yield and high turnover strategies are usually less tax efficient.

4.2 Calculating After-Tax Returns

The following three return calculations are used to measure tax efficiency.

4.2.1) After-Tax Holding Period Returns

Returns that are adjusted for the tax liability generated in the period. It is used to measure the tax efficiency of an investment strategy.

Pre-Tax Holding Period Return = R =

$$\frac{(End.\ Value - Beg.Value)\ +\ income}{Beg.Value}$$

After Tax Holding Period Return = R' =

$$\frac{(End.\ Value - Beg.Value) +\ income - Tax}{Beg.Value}$$

$$R' = R\ - \frac{Tax}{Beg.Value}$$

Cumulative after-tax returns (geometrically linking the monthly returns) = $R'_G = [(1 + R'_1) + (1 + R'_1) + \ldots (1 + R'_{1)}]^{\frac{1}{n}} - 1$

4.2.2) After-Tax Post-Liquidation Returns

Post Liquidation Return – calculates the resulting capital gains tax as if all portfolio holdings are sold on the analysis date. The ending portfolio value is determined by subtracting the capital gain tax.

This measure is used to determine the impact of embedded tax liability due to unrealized capital gains on the investor's ending wealth.

$$R_{PL} = \left[(1 + R'_1) + (1 + R'_2) + \ldots (1 + R'_{n)} - \frac{Liquidation\ Tax}{Final\ Value}\right]^{\frac{1}{n}} - 1$$

Where,

Liquidation Tax = (Final value – Tax basis) x Capital gains tax rate

Practice: Example 4, CFA Institute's Curriculum, Reading 22.

4.2.3) After-Tax Excess Returns

This measure is used to determine the impact of tax drag on the return benefits of a strategy by comparing after-tax returns against the benchmark. For example, whether the fund is generating sufficient alpha to cover fees and taxes.

Pre-tax excess return = $x = \mathrm{R} - \mathrm{B}$
After-tax excess return = $x' = \mathrm{R}' - \mathrm{B}'$
Tax alpha = $\alpha_{Tax} = x' - x$

Where,

- B and B′ are pre-tax and after-tax portfolio returns respectively.
- R and R′ are pre-tax and after-tax portfolio returns respectively.

4.2.4) Tax Efficiency Ratio (TER)

This is a ratio of after-tax annual return divided by pre-tax annual return. This measure is used to select managers based on the efficiency of their product offerings.

For example, which fund is suitable for the taxable account of an investor.

TER = $\frac{\mathrm{R}'}{\mathrm{R}}$

TER is used in combination with other measures.

Note: This ratio is useless when the returns are negative.

Practice: Example 5, CFA Institute's Curriculum, Reading 22.

5. TAXABLE, TAX-EXEMPT, AND TAX-DEFERRED ACCOUNTS: CAPITAL ACCUMULATION AND ASSET LOCATION

Investment accounts can be classified into the following three categories:

1. Tax-deferred accounts
2. Taxable accounts
3. Tax-exempt account

5.1 Capital Accumulation in Taxable, Tax-Deferred, and Tax-Exempt Accounts

1. Value of ***tax-exempt*** account compounds in a usual manner.

$$FV = (1 + R)^n$$

2. Value of ***tax-able*** account compounds using after-tax return R'.

$$FV = (1 + R')^n$$

3. Value of a ***tax-deferred*** account compounds using pre-tax return but pays taxes when assets are withdrawn. Assuming all assets are withdrawn, the future value would be:

$$FV = (1 + R)^n(1\text{-}t)$$

Practice: Example 6, CFA Institute's Curriculum, Reading 22,

5.2 Asset Location

Asset location refers to ***locating/placing*** investments (different asset classes) in suitable accounts i.e., tax-exempt, tax-deferred, taxable etc.

Generally,

- Assets that are taxed ***heavily*** should be held in tax-deferred and tax-exempt accounts (i.e., bonds).
- Assets that are taxed favorably (i.e., at lower rates) and/or tax deferral should be held in taxable accounts (i.e., equities or tax-free municipal bonds).

Practice: Example 7, CFA Institute's Curriculum, Reading 22.

6. TAXABLE, TAX-EXEMPT, AND TAX-DEFERRED ACCOUNTS: DECUMULATION STRATEGIES AND CHARITABLE GIVING STRATEGIES

A client's investment plan should be aligned with his financial, tax, and estate plans.

This section focuses on the retiring clients, their retirement accounts, and how to manage assets to support their needs and expenditures.

Tax-efficient decumulation strategy - strategies that consider taxes in deploying retirement assets to support spending requirements over the client's remaining life.

Retirement saving accounts are usually tax-deferred or tax-exempt. It is better to withdraw from taxable accounts first and allow the tax-exempt to compound.

Note: In a progressive rate tax structure, the tax rate increases with an increase in income. It is more tax-efficient to withdraw from the retirement account until the lowest tax bracket has been fully utilized.

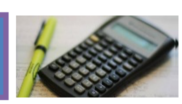
Refer to Example above Exhibit 8 for Tax-aware decumulation strategy, CFA Institute's Curriculum, Reading 22

6.1 Tax Considerations in Charitable Giving

Investment advisors should use an appropriate strategy if the client's financial plan also includes charitable giving.

For example, whether to gift appreciated securities to charitable organizations without triggering the capital gains or to gift low-cost basis assets from taxable accounts, thereby reducing the tax liability embedded in the portfolio.

Practice: Example 8, CFA Institute's Curriculum, Reading 22



7. TAX MANAGEMENT STRATEGIES AND BASIC TAX STRATEGIES

Tax avoidance versus Tax evasion

- **Tax avoidance** – is a legal activity about discovering approaches to minimize taxation by understanding tax laws.
- **Tax evasion** – is an illegal activity about concealing/not paying taxes that are due otherwise.

7.1 Basic Portfolio Tax Management Strategies

Basic portfolio tax management strategies are of two types:

1. **Structuring the investment legitimately to reduce the tax amount.** Such as:
   - Holding assets in a tax-exempt account
   - Investing in tax-exempt bonds
   - Qualifying for favorable tax treatment by holding assets/dividend-paying stocks for a longer period.
2. **Deferring the taxable income until some future date** Such as:
   - In a progressive tax regime, deferring assets till retirement if tax rates will be lower after retirement.
   - Reducing portfolio turnover.
   - Selling securities at a loss to offset realized capital gains – a strategy called ***tax-loss harvesting***.

Tax Loss harvesting: The practice of realizing capital losses that offset taxable gains in that tax year, resulting in a decrease in the current year's tax liability.

8. APPLICATION OF TAX MANAGEMENT STRATEGIES

This section covers many important topics related to tax-aware portfolio management such as:

- Choice of investment vehicle
- Tax lot accounting
- Tax-loss harvesting
- Tax deferral
- Quantitative tax management

8.1 Investment Vehicles

Assets of private clients are usually held in various forms of investment vehicles (such as mutual funds, partnerships, separately managed accounts, etc.). The structures of the investment vehicle affect the client's tax liability.

Partnership Structure:

- Funds operate free of taxes
- Taxes are passed through to the underlying partners.
- Funds' distributions are classified as capital gains

Mutual Fund:

- Dividends and interest income are passed through to the investors, who pay income taxes in the year received.
- Investors pay capital gain taxes on transactions within the fund- i.e., their proportionate share of the tax liability annually.
- If investors sell their mutual funds, taxes are paid on the capital gains.

Potential Capital Gain Exposure (PCGE): PCGE estimates the % of the fund's assets that represents gains based on the fund's assets that have been appreciated.

PCGE is used to measure the possible future capital gain distributions.

$$\text{PCGE} = \frac{\text{Net gains/losses}}{\text{Total net assets}}$$

Exchange-traded funds (ETFs) are more tax-efficient than mutual funds. Tax liabilities can be reduced or removed through the creation/redemption process.

Separately Managed Accounts (SMA):

- Offer greater flexibility because the asset has only one owner.

- Unlike mutual funds, realized losses within the SMA portfolio can be used to offset gains on assets held outside the SMA portfolio.

Practice: Example 9, CFA Institute's Curriculum, Reading 22

8.2 Tax Loss Harvesting

Losses can be used to reduce current year taxes. A simple way of using tax-loss harvesting technique is to realize a loss (by selling securities that are below their acquisition price) and use that loss to offset gains or other income.

In some jurisdictions trading solely for tax loss harvesting is not allowed.

In the United States, the '**wash sale rule**' applies across the taxpayer's accounts, which states that tax-loss credit will be rejected if the investor purchases the same or similar security within 30 days before or after the sale of the asset.

Disadvantages of tax-loss harvesting:

- The tax-loss harvesting is only a tax deferral strategy because when a security is sold at a loss and its sales proceeds are reinvested in similar security, the cost basis of the security is reset to the lower market value and thereby increases the future tax liabilities.

Tax lot accounting – keeping track of when an investment was purchased and how much was paid for the investment. It is based on prioritizing the realization of losses and gains.

Common methods of tax lot accounting are:

a) Fist in, first out (FIFO)
b) Last in, first out (LIFO)
c) Highest in, first out (HIFO)
d) Specified-lot (identifying specifically which tax lot to be traded)

Note: Tax lot accounting is not permissible in all jurisdictions.

Practice: Example 10, CFA Institute's Curriculum, Reading 22

8.3 Quantitative Tax Management

The quantitative approach to tax management is used to optimize the portfolio for tax efficiency such as to minimize tax drag and investment risk, execute loss harvesting strategy, delay the realization of gains, etc.

A quantitative model is used to estimate the risks and correlations of securities in the portfolio using inputs and algorithms to minimize tracking errors, realized gains, trading costs, and to maximize realized losses.

Transitions - Minimizing tax cost when transitioning to the new portfolio mandate.

Tax-optimized loss harvesting – Systematically monitoring the portfolio for tax opportunities throughout the year.

Gain-loss matching optimization – Using gain-loss matching optimization algorithm to avoid the realization of capital gains tax while keeping portfolio risk at a minimum relative to the benchmark.

Practice: Example 11, CFA Institute's Curriculum, Reading 22

9. MANAGING CONCENTRATED PORTFOLIOS AND RISK AND TAX CONSIDERATIONS IN MANAGING CONCENTRATED SINGLE-ASSET POSITIONS

A concentrated position occurs when an investor owns an asset that represents a large percentage of his overall portfolio.

The three major types of "concentrated position in a single asset" include:

1. **Publicly traded stocks –** Concentrated positions in publicly traded single-stock may occur as a result of:

- Stock received by company executives as part of their compensation.
- A large position in a single stock inherited by family members.
- An IPO of a private company.
- Stock is received by the seller of a privately owned business when the company becomes publicly traded.

2. **A privately-owned business** - ownership in privately owned businesses that is transferred down from one generation to the next.

   As family ownerships/businesses are usually smaller than public companies, the major concerns with such businesses may include:

   - Limited operating history
   - Undiversified business mix
   - Difficulty attracting good quality management
   - Constrained financing options

3. **Commercial or investment real estate** - Concentrated positions in real estate investments

9.1 Risk and Tax Considerations in managing Concentrated Single-Asset Positions

Four major risk and tax-related concerns regarding single-asset positions are:

1. Company-specific risk
2. Lack of portfolio diversification
3. Liquidity risk – high transaction cost
4. Tax Risk (higher taxes) - low tax basis can trigger significant tax liability.

A concentrated position in an investor's portfolio reduces the portfolio ***diversification*** and exposes the investor to significant ***company-specific risk (or industry-specific risk)***.

In addition, the sale of a concentrated position may raise substantial concerns about ***tax*** and ***liquidity***.

9.1.1) Approaches to Managing the Risk of Concentrated Positions

Key factors to consider when developing an appropriate strategy are:

- **Degree of concentration** - the higher the concentration, the higher will be the risk.
- **Volatility and downside risk of the position** – the higher the position risk, the greater the diversification benefit.
- **Tax basis** – the lower the tax basis, the higher the tax liability.
- **Liquidity** – the lower the liquidity, the higher will be the cost of risk-reduction.
- **Tax rate of the investor** – the higher the tax rate, the higher the tax liability.
- **Time horizon of the investor** – the longer the tax horizon, the better the chance to offset the tax impacts.
- **Restrictions on the investor** – if the investor has restrictions on an outright sale, other strategies should be planned.
- **Emotional attachment and other non-financial considerations** - emotionally attached clients should be advised by explaining the effects of an investment program on various investment goals.

Various strategies can be used to mitigate the risks of a concentrated position. Such as:

1. **Sell and diversify** - simply sell the security and re-invest the proceeds to reduce concentrated position.
2. **Staged diversification** – selling in tranches to mitigate the risk of inconvenient timing.
3. **Hedging and monetizing strategies** - hedging the value of the concentrated asset using derivatives and then applying monetization (borrowing against concentrated position) without incurring tax liabilities.
4. **Tax-free exchanges** – exchanging illiquid asset position with liquid stocks, without creating a taxable event.
5. **Charitable giving strategies** – Charitable trusts, private foundations, and donor-advised funds allow investors to transfer assets to the tax-exempt account. These assets can be sold without incurring capital gain taxes.
6. **Tax-avoidance and tax-deferral strategies** - Some jurisdictions allow step-up in basis on death, which eliminates capital gain taxes. Similarly, a tax loss harvesting strategy can be paired with a staged diversification strategy to match gains with losses. In this way, investors can spread and defer the tax burden over time.

10. STRATEGIES FOR MANAGING CONCENTRATED POSITIONS IN PUBLIC EQUITIES

10.1 Staged Diversification and Completion Portfolios

Investors manage the risk of a concentrated position by selling the position outrightly or through a ***staged diversification*** strategy. Another more sophisticated approach is the ***completion portfolio***.

Staged diversification: Selling the concentrated position over some time and reinvesting the proceeds in a diversified portfolio.

- **Benefits:** spread the tax liability across multiple tax years
- **Drawbacks**: extend the time during which the investor is exposed to a concentrated single asset position.

Completion Portfolio: It is an index-based portfolio that when added to the investor's concentered asset position forms an overall portfolio with exposure similar to the investor's benchmark.

- Securities are selected using the quantitative model optimization technique. The model rebalances the portfolio on an ongoing basis, minimizes active risk, and maximizes the after-tax portfolio return.

10.2 Tax-Optimized Equity Strategies-Equity Monetization, Collars, and Call Writing

Equity monetization: Set of strategies used by investors to receive cash for their concentrated single asset position without an outright sale.

Advantages:

- Generate short-term liquidity.
- Prevent triggering the capital gain tax.
- Investors can retain control of voting rights.

Monetization is a two-step process:

1. **Step 1:** Hedging the major portion of the concentrated position using a short sale, a total return swap, futures, forwards, options, etc. The larger the company, the more liquid the derivative market will be.
2. **Step 2:** Borrowing against the hedging position and investing the proceeds to create a diversified portfolio.

Whether equity monetization strategy will be treated as taxable or not depends on the jurisdiction.

Practice: Example 12, CFA Institute's Curriculum, Reading 22

10.3 Tax-Free Exchanges

Exchange fund: A partnership where each partner contributes low-cost-basis stock to the fund.

- Each partner owns a pro-rata share of a diversified pool of low-basis securities of the fund.
- Exchange fund participation is not a taxable event.
- Partners should remain in the fund for at least seven years.
- If redeemed, the partner receives a basket of securities that represent a pro-rata ownership of the fund.
- An exchange fund is a technique for achieving a tax-free exchange of a concentrated position.

Limitations:

- The portfolio manager has discretion on whether to accept the shares and on the composition of the basket at the time of redemption.
- 20% of the portfolio must be 'qualified assets.'
- The portfolio is less diversified than a typical portfolio
- Investors have to pay redemption fees for early withdrawal.

10.4 Charitable Reminder Trust

Charitable remainder trust: A trust that provides income for the life of named beneficiaries. When the last-named beneficiary dies, the remaining assets in the trust are distributed to the charity named in the trust.

The investor transfers his concentrated position to the tax-exempt charitable trust, which is a trust with a defined and charitable purpose. The contributions to the trust are tax-deductible for the investor and the trust would not be taxed on the sale or reinvestment of the shares.

Practice: Example 13, CFA Institute's Curriculum, Reading 22

11. STRATEGIES FOR MANAGING CONCENTRATED POSITIONS IN PRIVATELY OWNED BUSINESSES AND STRATEGIES FOR MANAGING CONCENTRATED POSITIONS IN REAL ESTATE

Strategies for business owners to generate liquidity (full or partial) include:

- Initial public offering
- Sale to a 3rd party investor
- Sale to an insider
- Divestiture of non-core assets
- A personal line of credit against company shares
- Recapitalization

11.1 Personal Line of Credit Secured by Company Shares

A business owner can generate liquidity to diversify its concentrated position without losing control of the business and without incurring an immediate tax liability (if structured properly) by obtaining a ***personal loan*** against its private company shares.

- The loan gives the lender a "put" option that gives the lender the right to demand repayment of the loan.
- The business owner can meet the put obligation either through its existing credit arrangement or with a standby letter of credit issued for this specific purpose.
- When the put option is exercised, it triggers a taxable event to the business owner.
- In addition, in most jurisdictions, the interest expense on the loan is currently deductible for tax purposes.

11.2 Leveraged Recapitalization

In a leveraged recapitalization, a business owner sells a large portion of his business equity to a seller (i.e., private equity firm) for cash and retains a minority ownership interest in that ***recapitalized*** entity.

The investor can invest those after-tax cash proceeds in other asset classes to create a diversified portfolio.

The retained minority ownership interest in the business motivates the owner to grow the business.

Recapitalization strategy is preferred by middle-market business owners who want to reduce concentration risk and generate liquidity without selling the business entirely.

11.3 Employee Stock Ownership Program

A business owner can sell some or all of the company's shares by selling shares to the employees through an employee stock ownership plan (ESOP).

- In a ***leveraged ESOP***, the ESOP can borrow capital from a bank to finance the purchase of the owner's shares, provided that the company has borrowing capacity.

11.4 Strategies for Managing Concentrated Positions in Real Estate

Real estate may represent a significant portion of a private client's net worth. Like private business owners, real estate owners tend to underestimate the risks of their real estate and overestimate their value.

Risks of Investment Real estate include:

- Concentration risk
- Illiquidity
- Greater tax liability on liquidation of the property as the property may be highly appreciated relative to its original tax cost basis.

Types of Monetization strategies for Real Estate Owners include:

- Mortgage financing (recourse/non-recourse, fixed/floating rate)
- Charitable trust
- Donor-advised funds

11.5 Mortgage Financing

a) Outright sale of the property: It is the *most common* strategy used by investors to reduce a concentrated position in a particular property and to generate liquidity to diversify asset portfolios.

b) Mortgage Financing:

- It refers to obtaining a fixed-rate or floating-rate mortgage against the property.
- It is the *second most common strategy* used by investors to reduce a concentrated position in a particular property and to generate liquidity to

diversify asset portfolios BUT without incurring an immediate tax liability.

- The investor can invest the loan proceeds in a liquid, diversified portfolio of securities.
- The mortgage can be a recourse or non-recourse loan. In a ***non-recourse loan***, the only resource available to the lender in the event of default is the *mortgaged property*.

Advantages of Mortgage financing:

- For tax purposes, the loan proceeds do not represent "income" and therefore are not taxed. In addition, if the value of the real estate increases over time, the investor can borrow additional debt against the property without incurring a tax liability.
- **Cash-flow Neutral LTV (loan-to-value) ratio** is the ratio where the *Net rental income generated from the property = Fixed mortgage payment (composed of interest expense and amortization of the loan principal)*.
- If an investor achieves a cash flow-neutral LTV ratio, he/she is able to obtain a loan against the property with no limitations on the use of the loan proceeds.
- Another benefit to the investor is that he/she can use net rental income on the property to pay servicing cost of the debt and other expenses of the property, leading to zero net income from the real estate.

11.6 Real estate Monetization for the Charitably Inclined-An Asset Location Strategy

Donor-advised fund (DAF): An investor can transfer the asset with potentially greater growth prospects to a DAF in order to grow the asset tax free. When the DAF then sells the property to generate liquidity, it does not incur an immediate tax liability because DAF is a charitable organization.

Practice: Example 13, CFA Institute's Curriculum, Reading 22

12. DIRECTING AND TRANSFERRING WEALTH AND OBJECTIVES OF GIFT AND ESTATE PLANNING

Effective multigenerational wealth management requires the basics of estate planning and common estate planning strategies as well as managing several related issues.

12.1 Objectives of Gift and Estate Planning

Estate: All sorts of properties, which a person owns including tangible, financial, immoveable intellectual properties. Such as stocks, bonds, bank accounts, royalties, real estate, commodities, artwork, vehicles, etc.

Estate Planning: It is a definite plan that specifies the rules regarding the administration and disposition (transferring) of one's estate during one's lifetime and at one's death.

Key objectives of effective estate and gift planning include:

1. **Maintaining sufficient income and liquidity:**
   - maintaining desired lifestyle of donors and beneficiaries.
2. **Deciding on control over the assets:**
   - clients may desire to retain control over the assets/investments passed to the next generation or to the charitable activities of their money supports.
3. **Asset protection:**
   - Under Forced Heirship rules, wealth owners have limited decision power, and heirs have the right to a fixed share of a parent's estate.
   - In some jurisdictions, trusts protect assets from creditors by legally separating the trust from beneficiaries.
   - In some jurisdictions, trusts are used to avoid forced heirship.
4. **Transferring assets in a tax-aware manner:**

   The main forms of taxes on wealth transfer are:
   - **Gift tax** – the tax on gifts made during one's lifetime
   - **Inheritance tax** – the tax on bequests upon one's death
   - **Generation-skipping tax:** Tax levied on asset transfers that skip one generation i.e. when clients transfer the asset to their grandchildren.
5. **Preservation of family wealth:**
   - an effective family governance system based on jointly agreed on investments can help in preserving and growing wealth across generations

6. **Business succession:**
   - owners make important decisions about assigning managerial responsibilities and how to pass control and beneficial ownership of the family business to the next generation.

7. **Achieving charitable goals:**
   - in most jurisdictions, gifts to charitable organizations are fully excluded from gift taxes or qualify for an estate tax deduction (if donations are made during the donor's life) or gift tax.

Practice: Example 15, CFA Institute's Curriculum, Reading 22

13. GIFT AND ESTATE PLANNING STRATEGIES, INTRODUCTION TO ESTATE PLANNING: WILLS, PROBATE AND LEGAL SYSTEMS, AND LIFETIME GIFTS AND TESTAMENTARY BEQUESTS

Smooth transition of wealth requires the right estate planning or gift strategy depending on the client's goals and legal system.

13.1 Introduction to estate planning: Wills, Probate, and Legal Systems

- **Will or testament** - is a document that explains the rights of others over one's property after death.
- **Testator** - a person who authored the will and whose property is disposed of according to the will.
- **Probate** - is the legal process that validates the Will, supervise the orderly distribution of decedent's assets to heirs, so that all interested parties can trust its authenticity.
- **Intestate:** A person who dies without a Will is said to have died intestate. In this case, a person is appointed by a probate court to receive all claims against the estate, pay creditors and then distribute all remaining property in accordance with the laws of the state.
- **Trust** - a legal relationship through which an individual entrusts assets to trustees, who manage the assets for the benefit of the assigned beneficiaries.
  - A trust may be either testamentary (created through testator's will) or living (created during the settlor's life).
  - A trust is not a legal person, but a legal relationship. A trust cannot hold assets or enter into contracts in its own name. Trustee is the legal owner of the assets.

13.2 Lifetime Gifts and Testamentary Bequests

Testamentary gratuitous transfer/Testamentary bequest - Bequeathing or transferring assets upon one's death is referred to as testamentary gratuitous transfer from the perspective of the donor and inheritance from the perspective of recipient.

Note: Many civil law countries place restrictions on testamentary disposition. For example, the forced heirship claim can be avoided by gifting or donating assets to others during the lifetime to reduce the value of the final estate upon death.

Whether to gift assets during life or after death depends on various aspects such as: tax structure and asset's expected rate of return.

In jurisdictions where an estate or inheritance tax applies, gifting assets to others can be a valuable tool in estate planning. Gifts can help to reduce the taxable estate, resulting in decrease in estate or inheritance taxes.

The benefit of transferring wealth through gifting using tax-free allowance is that the donor is not obligated to pay any gift or estate tax on the capital appreciation on gifted assets; however, the appreciation on gifted assets is still subject to tax on investment returns (i.e. dividends and capital gains) irrespective of gifting.

Charitable Gratuitous Transfers In most jurisdictions, gifts to charitable organizations are fully excluded from gift taxes. Wealth transfers to not-for-profit or charitable organizations have the following three forms of tax relief under most jurisdictions.

1) Donations to charitable organizations are not subject to gift transfer tax.
2) Donations to charitable organizations are income tax deductible.
3) Donations to charitable organizations are not subject to taxes on investment returns.

Practice: Example 16 and 17, CFA Institute's Curriculum, Reading 22

13.3 Efficiency of Lifetime Gifts versus Testamentary Bequests

Tax-Free Gifts

In general, the relative after-tax value of a tax-free gift made during one's lifetime compared to a bequest that is transferred as part of a taxable estate is estimated as follows:

$$RV_{TaxFreeGift} = \frac{FV_{Gift}}{FV_{Bequest}}$$
$$= \frac{\text{After tax future value of gift}}{\text{After tax future value of taxable transfer of bequest}} = \frac{[1+r_g(1-t_{ig})]^n}{[1+r_e(1-t_e)]^n(1-T_e)}$$

Where,

T_e = estate tax if the asset is bequeathed at death
r_g = pretax return to the gift recipient
r_e = pretax return to the estate making the gift
t_g = effective tax rates on investment returns on the gift recipient
t_e = effective tax rates on investment returns on the estate making the gift
n = Expected time until the donor's death

Interpretation:
- When **$RV_{TaxFreeGift}$ > 1,** it indicates that gifting assets immediately is more tax efficient than leaving them in the estate to be taxed as bequest.

Taxable Gifts

The value of making taxable gifts rather than leaving them in the estate to be taxed as a bequest is estimated as follows:

$$RV_{TaxableGift} = \frac{FV_{Gift}}{FV_{Bequest}}$$
$$= \frac{\text{After tax future value of taxable gift}}{\text{After tax future value of taxable transfer of bequest}} =$$
$$= \frac{[1+r_g(1-t_g)]^n(1-T_g)}{[1+r_e(1-t_e)]^n(1-T_e)}$$

where, T_g = Tax rate applicable to gifts. In addition, it is assumed that the recipient, NOT the donor, pays the gift tax.

Interpretation:
- When **$RV_{TaxableGift}$> 1.00,** it indicates that gifting assets immediately is more tax efficient than leaving them in the estate to be taxed as bequest.

Practice: Example 18, CFA Institute's Curriculum, Reading 22

14. ESTATE PLANNING TOOLS: TRUSTS, FOUNDATIONS, LIFE INSURANCE, COMPANIES

Common estate planning tools include:

1) Trusts (a common law concept)
2) Foundations (a civil law concept)
3) Life insurance
4) Companies

Trust

A trust is a real or personal property held by one party (trustee) for the benefit of another (beneficiaries) or oneself (grantor).

Settler: The person who makes the trust is called "Grantor" or "Settler".

Trustee: The person who manages the trust assets and performs the functions of the trust according to the terms of the trust is called "Trustee". The trustee may be the grantor or may be a professional or institutional trustee. There may be one or several trustees. Trustees have legal ownership of the trust property.

Beneficiary: The person or persons who will benefit from the creation of trust is called "beneficiary". The beneficiary is not the legal owner of the trust assets. The beneficiary is entitled to receive income from the trust.

Two main dimensions to categorize trusts are
1. revocable or irrevocable
2. fixed or discretionary

1. Trusts can be either revocable or irrevocable:

- ***Revocable trust:*** A revocable trust is a trust in which the grantor retains control over the trust's terms and assets i.e., any terms of the trust can be amended, added to or revoked by the grantor during his/her lifetime. In a revocable trust arrangement, the grantor is considered to be the owner of the assets for tax purpose; hence, the grantor (not trust) is responsible for any tax related or other liabilities associated with trust's assets. Thus, in a revocable trust, trust assets are not protected from the creditors' claims against a settlor.

- ***Irrevocable trust:*** An irrevocable trust is a trust that can't be amended or revoked once the trust agreement has been signed. In an irrevocable trust, the trustee is considered to be the owner of the assets; hence, the trustee (not settlor) may be responsible for tax payments and trust assets are protected from the creditors' claims against a settlor.

2. Trusts can be structured to be either fixed or discretionary:

- **Fixed Trust:** In a fixed trust, the amount and timing of distributions are pre-determined by the settlor (i.e. are fixed) and are documented in the trust documentation; they are not determined by the trustee.
- **Discretionary Trust:** In a discretionary trust, as the name implies, the trustee has the discretion to determine the amount and timing of distributions based on the investor's general welfare.

Objectives of using a Trust Structure:

1) Control: Transferring assets via trust structure allows the settlor to transfer assets to beneficiaries without losing control on those assets.

2) Asset protection: Assets transferred through irrevocable trust structure are protected from the creditors' claim against the settlor. Similarly, in discretionary trusts, the assets are protected from creditors' claims against the beneficiaries. In some jurisdictions, the trust assets are also protected from forced heirship claims.

3) Tax reduction: Trusts can be used to reduce taxes because the income generated by trust assets may be taxed at a lower/favorable tax rate. In an irrevocable, discretionary trust, the distribution in a particular tax period to the beneficiary may be determined by the trustee depending on the beneficiary's tax situation. Similarly, a trust can be established in a jurisdiction with a low tax rate or even no taxes.

4) Avoidance of probate process: By transferring legal ownership of the assets to the trustee, the settlor can avoid the lengthy probate process.

Foundation

Foundations are typically established to hold assets for a particular purpose, e.g., to fund education, hospitals, or to help the needy, philanthropic works etc. It is a civil law system concept.

When a foundation is established, funded, and managed by an individual or family, it is referred to as 'Private Foundation'.

- Like trusts, the objectives of using foundations include control, avoidance of probate, asset protection, and tax reduction.
- Unlike trusts, a foundation is a legal person.

Life Insurance

Like trusts, life insurance provides tax and estate planning benefits. These benefits are as follows:

- Death benefit proceeds to life insurance beneficiaries are exempt from taxes in many jurisdictions.
- Life insurance facilitates the policy holder to transfer assets directly to policy beneficiaries outside the lengthy and complex probate process.
- Assets transferred (i.e. premium) reduce the value of policy holders' taxable estate, leading to decrease in estate tax. In addition, premium is not subject to a gratuitous transfer tax.

Companies and Controlled Foreign Corporations

Controlled foreign corporation (CFC) is a company in which the taxpayer has a controlling interest (according to the home country law) but the company is located outside a taxpayer's home country.

- Transferring assets in a CFC helps to defer taxes on earnings of the company until the earnings are actually distributed to shareholders or the company is sold.

Practice: Example 19, CFA Institute's Curriculum, Reading 22

15. MANAGING WEALTH ACROSS GENERATIONS, GENERAL PRINCIPLES OF FAMILY GOVERNANCE, FAMILY CONFLICT RESOLUTION, AND FAMILY DYNAMICS IN THE CONTEXT OF BUSINESS EXIT

A successful family governance system is crucial for effective transition, preservation, and growth of wealth over time.

Family businesses and transfer of wealth are affected by behavioral and emotional challenges including generational conflict, sibling rivalry, family tensions, etc.

15.1 General Principles of Family Governance

Family Governance: the process of family's cooperative decisions making and communication, based on their common family values to serve current and future generations.

Common purposes served by family governance include:

- Establishing principles for collaboration among family members
- Preserving and growing family wealth
- Increasing human and financial capital across generations

Family governance framework consists of:

- formal legal documents
- non-binding family agreements
- collectively defined and agreed on goals and values

15.2 Family Conflict resolution

Conflict resolution mechanism is an important element for shared ownerships and investments. Conflict resolution is relatively challenging in the case of family businesses.

Family Constitution: An agreed-upon set of rights, values, and responsibilities stated in a non-binding document.

Family constitutions are the starting point of conflict resolution.

15.3 Family Dynamics in the Context of Business Exit

Business succession planning becomes highly critical if the business is the core of the family's wealth.

Key considerations

1. <u>The transition of the business to the new generation:</u> Creating a governing body (including external board members) may play an important role in the smooth transition of the business across generations.by providing an independent perspective.

   A family council should focus on balancing liquidity needs and capital and should represent family members from each generation to maintain healthy communication.

2. <u>Sale of the business:</u> Selling a family business may be emotionally challenging for the founder(s) and family due to endowment bias.

   Private wealth advisors should counsel emotionally biased clients by providing quantitative measures to ensure the smooth execution of the business sale.

3. <u>Considerations related to the timing of business sale:</u> One tax-saving strategy is to transfer ownership of the to trust before the actual sale of the business. This can also lower gift and estate tax liability.

4. <u>Selection of trustee:</u> One important decision is trustee selection. Individual trustees can understand family aspirations better but tend to have higher management costs and lower skills as compared to institutional trustees.

   Beneficiaries do not have direct access to trust assets but may participate in trust decision-making, depending on applicable trust laws in the jurisdiction.

5. <u>Post-sale considerations:</u> A suitable structure (about how to use the cash generated from the business sale) should be placed in advance to meet objectives of keeping the family united in achieving family goals identified by the founders.

16. PLANNING FOR THE UNEXPECTED

16.1 Divorce

Marital laws vary across jurisdictions. On the dissolution of a marriage, courts may intervene to make financial arrangements between former spouses.

In some jurisdictions (such as in the United Kingdom), family assets of divorcing couples are divided into 50/50 basis.

An critical problem with the 50/50 asset division is that it is not only applicable to matrimonial assets but also to inherited assets available to the spouse.

- **Pre-nuptial agreements:** when arrangements between couples in relation to financial matters are decided before the marriage.

- **Pot-nuptial agreements:** when arrangements between couples in relation to financial matters are decided after the marriage.

Discussing pre-or post-nuptial agreements is a highly sensitive and personal matter. Some families through trust require a pre-nuptial agreement as a condition for their younger generation.

16.2 Incapacity

As a result of improvements in medical care and nutrition, the average age of humans has increased to 100 as opposed to 75.

However, the increase in longevity has also raised issues such as a variety of disabilities, dementia, etc.

Owners may appoint a guardian to make decisions on their behalf (both business and personal health-related) in case of disability. This type of unplanned transfer of decision-making may bring two primary risks:

1. The authorized person may not be fully aware of the business and family situation
2. The process may take time

Living Wills: A legally binding document where people express their wishes in case, they become incapacitated.

Practice: End-of-Chapter Questions from CFA Institute's Curriculum, Reading 22 and FinQuiz Question-bank.