The Five Mistakes In Creating A Trust

A trust can help you transfer large amounts of money to loved ones or charities while reducing or eliminating taxes and guaranteeing that your bequest will conform to your wishes and benefit the people or institutions you choose. But trusts can be complex, and setting one up wrong can be terribly costly. So here's some help: a layperson's guide to avoiding trust mistakes.

The Wrong Trustee. A trustee is the person or institution you choose to administer the trust. The trustee manages trust assets, files tax returns, and handles other paperwork. You could select almost anyone: a trusted family member or friend; a lawyer or financial advisor; a bank or trust company. But an individual could die, and a lawyer or advisor might have a conflict of interest; by deciding to manage trust assets himself, he could earn an additional fee, even though an outside manager might do a better job. An institution, while it may avoid such conflicts, can be impersonal and inflexible, and its fees may be high. One solution is to have co-trustees: an individual you trust and a large institution.

Premature Termination. Lawyers often draft trusts that terminate on a certain date. Trust documents might call for your child to receive funds in three equal installments, at age 30, 35, and 40. But what if your child is sued for divorce or goes bankrupt just before a disbursement, or wants to use trust funds to open a body-piercing shop? If you don't name a termination date and give the trustee discretion to hold back payments, you could protect assets from creditors, court judgments, and poor judgment.

Lack of Flexibility. Once you've created an irrevocable trust, you won't be able to alter its language. But you can build in flexibility—for example, including a provision that will let you change the trust location if tax laws change or if another location would provide better protection against creditors. The trust could also provide for a "trust protector" who has the right to change trustees. This could be someone you trust but who doesn't have the skills to manage and administer the trust. Similarly, you could give a family friend the right to change beneficiaries or reduce a beneficiary's share.

Mandatory Income. Husbands often set up trusts that call for their wives to get all the income on trust assets upon their death, and that leave assets not used by the wives to their children upon her death. This could turn into a costly error. Suppose the surviving spouse ends up in a nursing home. Trust assets could be used up to pay nursing home bills; lacking those assets, the wife might be able to qualify for Medicaid, which would provide funds to keep her in the same institution. To solve this problem, you could give someone you trust the discretion to decide whether to make distributions, which could then be halted under special circumstances.

The Wrong Lawyer. A generalist may have trouble correctly drafting a complex trust, whereas a specialist in estate planning should know how to add flexibility to your trust and be able to create a trust that avoids common mistakes. ●

Harvest Tax Losses

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for a loss if you replace the securities you sold with others that are "substantially identical." This prohibition begins 30 days before the day of the sale, and ends 30 days afterward. If you sell and buy something that's basically the same during those 61 days, you're canceling or "washing" out the effects of the two transactions. The IRS figures nothing has really changed. Ergo, the wash-sale rule—and no deduction.

If you're a bond investor, you can comply with the rule yet stay in the market with a tax swap—selling individual bonds that have losses and reinvesting in the bonds of other companies that offer similar credit quality and comparable yields.

With stocks, a swap is similar. If you sell a stock for a loss, you are not permitted to take a deduction on the loss if you buy the same stock for 61 days. You also may not buy an option on the stock, or buy bond or preferred shares convertible in the stock without losing the deduction. You can, however, immediately replace the stock with shares in a different company in the same industry.

The wash sale rules on mutual funds and exchanges traded funds work the same way. If you sell a fund investing in the Standard & Poor's 500, you could not replace with another index fund investing in the S&P 500. But replacing it with a fund investing in the S&P 100 or a large-cap value stock index would be okay.

Just keep in mind that the IRS has steadfastly declined to comment on how the "substantially identical" standard applies to these baskets of securities.

Most experts agree you'd be violating the wash-sale rule if, within the 61-day period, you sold one fund family's Standard & Poor's 500 index offering and bought another S&P fund from another family. A safer move would be to reinvest in a vehicle that tracks a different large-cap index, such as the Russell 1000, or perhaps to replace the S&P 500 position with a subset of it—an S&P 100 fund, the S&P 500/BARRA Growth iShare (an ETF holding about 170 stocks), or the S&P 500/BARRA Value iShare. ●

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Now's The Right Time To Harvest Your Tax Losses

Have you sold investments or a business at a profit this year? Maybe you'd just like to shave your 2004 tax bill. You should always base portfolio decisions on your financial goals and risk tolerance, rather than on tax considerations. Still, under the right circumstances—for example, if you've realized short-term gains, or the prospects for particular holdings have dimmed—taking losses in taxable accounts can be helpful. Just follow the rules and act by December 31.

How Much Can You Save? The benefit of tax-loss harvesting depends on several factors, including your ordinary tax bracket, whether your loss reduces a capital gain, and whether that gain is short- or long-term. Consider these three situations:

- Scenario 1: You sell long-term holdings at a $13,000 loss. Because you had no gains to offset the losses, your immediate tax benefit is limited to a $3,000 deduction—the most you're allowed to take as a net capital loss against your regular income. If you're in the 33% bracket, you save $990 this year. You may carry forward your undeducted loss—$10,000—to future years, either to offset gains or to take as additional $3,000 deductions.
- Scenario 2: You realize the same long-term loss of $13,000, but here you have a short-term capital gain. You deduct that $3,000 net loss as before, saving $990. But you also avoided paying tax on the $10,000 gain—which, because it's short-term, would have counted as regular income. That saves you $3,300, for a total tax break of $4,290.
- Scenario 3: Same $13,000 long-term loss, but this time you realized a $10,000 long-term gain. You deduct your $3,000 loss, saving $990. However, your long-term gain would have been taxed at only 15%, limiting your avoided tax to $1,500. Total savings: $2,490.

Under the right circumstances, if you've realized short-term gains, or the prospects for particular holdings have dimmed—taking losses in taxable accounts can be helpful

To calculate potential savings, start by combining short-term gains and losses, then do the same for assets held more than a year. Your losses reduce or eliminate gains taxes triggered by mutual fund distributions and sales of securities, business interests, rental property, or other capital assets, including your home, assuming your profit exceeds the $250,000 per person exclusion.

Next, combine the short- and long-term categories. If this creates a net loss, you can deduct up to $3,000 from your income. You may carry forward additional losses to use next year or later, for as long as you live. Normally, though, you shouldn't create more losses than you expect to use within a few years.

There's one trick here. The IRS doesn't allow a current deduction

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You Could Buy A Dream, Or Do Real Financial Planning

The TV commercials and newspaper ads extol the advantages of a 401(k) to build retirement savings. They paint a rosy picture of golden years filled with travel, hobbies, and fun activities and talk about how, with the miracle of compounding, account balances can grow to six- and seven-digit sums. Don't fall for it. They're selling dreams.

When you retire, if all you want to do is sit and take it easy, understand that there's a big cost to doing so. You may need more than you realize to make your retirement plan work.

Many investors have a financial blind spot. They make plans for retirement and make investments, but then fail to match up the two. If you're going into your retirement with $500,000 in savings, for instance, you better not have $1 million worth of retirement plans. The same applies to kids' weddings, vacations, and other life events. Plans have to be funded from your savings and investments.

No, you can't project costs exactly. Plans are ever-changing. But as you approach retirement, you must have a good idea of how much you will need to live the lifestyle you want. Then, you can determine whether your plans are realistic. That's financial planning—not selling dreams.

Getting Help To Care For Mom And Dad

After being treated for a stroke, your widowed mother is ready to be released from the hospital. You don't think she can return to living on her own, but traveling across the country to live with you is also out of the question. You need to find the right kind of rehabilitation facility. The hospital social worker has recommendations, but can you trust her?

As more and more baby boomers find themselves caring for their parents, some are discovering qualified, objective advice from a relatively new source—a Geriatric Care Manager (GCM). With training in gerontology, social work, nursing, or counseling, a local GCM knows the cost, quality, and availability of services in your community and can help your family make prudent choices to care for parents.

"I tour the facility and talk to staff, review the state's grading system, and complete a financial background check to make sure the company isn't about to go bankrupt," says Francis A. Regan, a GCM in Boston.

Geriatric care managers conduct care-planning assessments to identify problems, evaluate your loved one's eligibility for government assistance, and even screen, arrange, and monitor in-home help. By matching services to clients' needs, they help contain costs. A geriatric care manager can also serve as a liaison for family members living at a distance, letting them know how things are going and alerting them about problems. Some care managers also provide family or individual therapy or guardianship assistance.

Emotions, flare-ups among siblings, and resentment between parents and children can boil over when making decisions about caring for Mom or Dad. Financial, geographical and logistical complications cause clashes that an outside objective expert can defuse with clear thinking, communication, and a dedication of time to solve a problem.

Before hiring a GCM, thoroughly check the background and qualifications of several candidates after speaking or meeting with them. Many GCMs are former social workers, therapists, nurses, or health-care administrators, but anyone can use the GCM title, even if they have no formal training or experience. Find out whether the person you're considering belongs to the National Association of Professional Geriatric Care Managers (www.caremanager.org) and is licensed in his or her profession. The association's website also includes information about what geriatric care managers do, and offers care management resources and assistance in finding a geriatric care manager. ●

Don't Just Park Cash; Drive Strong Yields

These days, with money market funds paying less than the inflation rate—before taxes—it's hardly worth the trouble to move cash out of your checking account. But if you have a substantial sum wasting away, there may be ways to double, triple, or even quadruple your yield. And, if you are willing to substitute a longer-term investment for a portion of your cash position, it opens up a number of alternative high-quality investments. You could employ a combination, allocating different amounts to each vehicle, depending on your needs and comfort level. The best place to start is where you are. Many fund companies have a higher-paying premium money fund for lofty balances. If you're holding more cash these days, you might qualify. You could earn an additional 0.15% to 0.20% (15 to 20 basis points) simply by making a phone call.

ETFs. A low-cost Exchange Traded Fund (ETF) that tracks a one-year to three-year U.S. Treasury bond may be worth considering. While you won't make out as well as you would in a money market fund if interest rates rise, an ETF is very liquid. You can buy or sell whenever markets are open, and investors recently received monthly interest payments that yielded about 1.5%. Keep in mind, ETFs, like mutual funds, are subject to market risk and potential loss of principal. Ultra-short-term bond mutual funds, another alternative, have proved volatile in 2003 but could also work for you.

Depository products. Compare accounts offered by banks, thrifts, and credit unions. If you shop around, you ought to be able to snag a better-than-money-market rate. Internet sites such as www.bankrate.com can point you to savings vehicles available across the country. Be sure an account offers the protection of the Federal Deposit Insurance Corp. coverage in case the institution becomes insolvent, and be aware that FDIC insurance does not cover accounts greater than $100,000.

Fixed annuities. Sold and backed by insurance companies, a fixed annuity is a contract that pays a set return, with the interest compounding until you make a withdrawal. There is a 10% penalty for pulling out earnings before age 59½, but even if you lose that portion of the income, a 3% fixed contract, for example, can net you considerably more than a money fund. You do have to watch out for surrender fees.

Municipal money market funds. In today's environment of microscopic interest rates, the difference between higher taxable yields and the lower yields of tax-free municipals has been compressed, particularly for short maturities. Still it is worth checking if munis make sense for you. You can find the current yields of both taxable and tax-free money funds at www.imoneynet.com.

To calculate the difference between what a taxable versus tax-free yield puts in your pocket, divide the muni's yield by one minus your tax rate. The result tells you the taxable yield needed to match the muni. If a fund is touted as "double tax-free" for residents of your state—free from state as well as federal income tax—use your combined tax rate in the formula.

Treasury Inflation-Protected Securities. TIPS are U.S. government –issued instruments that boost your principal to keep up with inflation. Because your money is tied up for the term of the note, TIPS aren't generally considered money-market substitutes. But they can protect your purchasing power and are liquid, so putting a portion of money you set aside for financial emergencies in TIPS is worth considering. If the Consumer Price Index rises 2%, a TIPS' $1,000 face value turns into $1,020—and although your fixed interest rate doesn't change, the larger principal translates into higher interest payments. But you're taxed on the principal growth in the year it's calculated, even though you won't receive that money until the bond matures, which is a drawback.

If inflation is surprisingly tame, as it has been in 2003, TIPS will underperform traditional Treasurys, however. Although if prices rise more than the market expects, you will earn more with TIPS than traditional Treasurys.

TIPS' prices often move independently of stock or bond prices, or conventional Treasurys, which can help diversify a portfolio. Also, because TIPS are less volatile than regular government issues, their market value declines less than that of other Treasurys when interest rates rise. ●

Business Owners Must Diversify Beyond Their Companies

You may have a great business, but unless you pull money out of it and diversify into other investments, you could be dooming your family company to failure—particularly when it's time to hand the reins to your children.

"The problem is that most family business owners are so consumed with the business that it's all that matters to them," says Andrew Keyt, executive director of Loyola University Chicago Family Business Center. "It's okay to be single-minded, but you also need to diversify."

Keyt, whose not-for-profit group educates entrepreneurs running small- and medium-sized companies, estimates that nine out of 10 owners of small businesses have virtually all of their net worth concentrated in those operations. "The bigger the business gets, the more likely the owners are to diversify," he says, "But it's typical that owners of successful businesses with annual revenues of $5 million or less have more than 90% of their wealth tied up in the business."

It's important for owners of small businesses to think about their own futures, rather than focusing exclusively on the future of their company. And that means pulling cash out of the business and investing in other assets—securities, real estate, another business, or any of a wide range of other investment opportunities.

Keyt says business owners should get in the habit of reallocating assets as soon as their businesses become profitable. Obviously, some earnings will have to be pumped back into the company to keep it growing. But without a strategy to divert some profits into other investments, you'll make it harder for your children to take over the business.

It's estimated that just 30% of all

And That Makes Succession Easier

family businesses survive the passage to a second generation, and only 11% continue to exist under a third generation of owners. And while estate taxes are often blamed for killing off family businesses, Keyt thinks the real culprit is controlling shareholders who fail to diversify into other assets.

If you have little liquidity outside of your business, it makes the succession to the next generation much more emotional, says Keyt. "Because the parents' financial fate is so tied up in the successful continuance of the business, the succession process is much riskier and creates a lot more tension. You're less likely to let your children take over." In contrast, parents who have a financial life outside their business will be much better prepared to let the kids start running the show.

"You need to be able to re-launch your children, just as you did when they went off to college," says Keyt. "You have to give them the freedom and control to take the business where they want it to go. And the only way you can do that successfully is by being diversified in assets outside of the company so that your financial fate is no longer dependent on how they run the company." ●