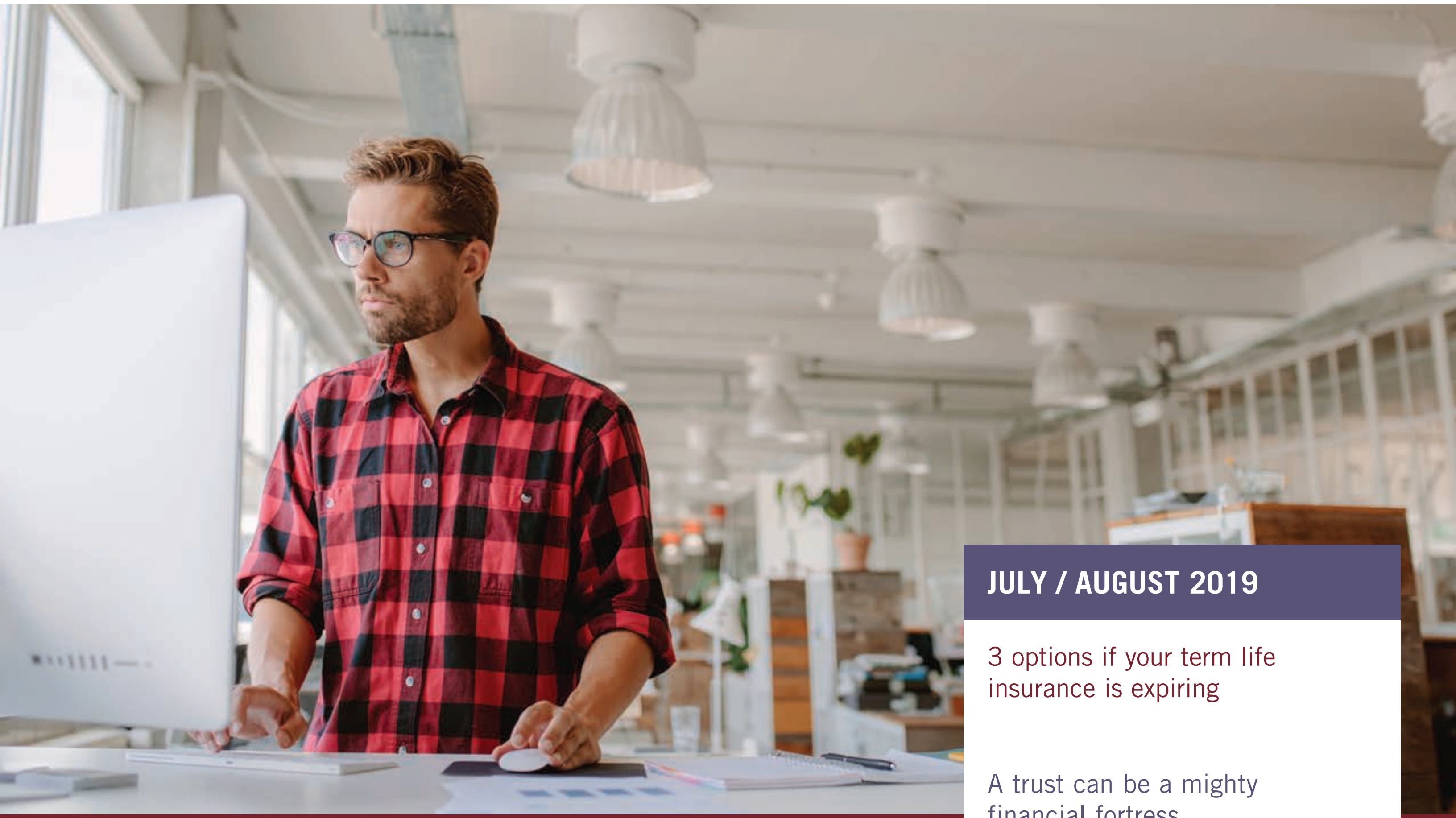
WEALTH MANAGEMENT ADVISOR



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QSBS OFFERS REMARKABLE TAX BREAKS

But be sure to follow strict rules

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An often-overlooked provision of the U.S. tax code — Section 1202 — offers investors a remarkable tax break: the ability to exclude up to 100% of the gain on the sale of qualified small business stock (QSBS). "What's the catch?" you might ask. For one thing, you must hold the stock for more than five years to enjoy the benefits. And the types of stock that are eligible are limited. However, under the right circumstances, you (or your heirs) can sell these securities federally income-tax-free.

Brief history

Sec. 1202 was enacted in 1993. Initially, it allowed noncorporate taxpayers to exclude from income 50% of their gain on the sale or exchange of QSBS. The remaining 50% was taxed at 28%. In 2003, the tax break fell out of favor when the regular long-term capital gains tax rate was cut to 15% (20% for high-income taxpayers).

But Congress breathed new life into QSBS when it temporarily increased the exclusion to 75% in 2009 and then to 100% in 2010. In 2015, Congress made the 100% exclusion permanent for stock acquired after September 27, 2010.

How to qualify

To qualify as QSBS, stock generally must be issued by a U.S. C corporation to an individual or an entity other than a C corporation. It also must meet the following requirements:

Gross assets. The issuing corporation's aggregate gross assets must not have exceeded $50 million at any time after August 10, 1993, or immediately after issuance of the stock. If the corporation's aggregate gross assets grow beyond this threshold at a later date, the QSBS maintains its favorable treatment.

Original issuance. You must acquire the stock as part of an original issuance — directly from the corporation or through an underwriter, not from another shareholder — in exchange for money or property other than stock. Stock received as compensation for services, or as a gift or inheritance, also qualifies.

Active business. The corporation typically must use at least 80% of its assets (by value) in the conduct of one or more qualified active businesses. Several types of businesses *do not* qualify, including:

- Farming,
- Certain oil, gas and mining,

- Banking, insurance, financing, leasing and investing,
- Hotels, motels and restaurants, and
- Service businesses in the health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage service fields.

In addition, no more than 10% of the corporation's assets may consist of real estate that's not used in conducting a qualified active business.

Holding period. You must hold QSBS stock for at least five years after it's issued. If the stock is transferred by gift or inheritance, the transferor's holding period is added to the recipient's. Suppose, for example, that Ken purchases QSBS on January 1, 2014, and dies on January 1, 2017. His daughter, Kate, inherits the stock and sells it on February 1, 2019. Even though Kate has held the stock for only two years, she qualifies for 100% gain exclusion because Ken's three-year holding period is added to hers.

If your QSBS is converted into different stock of the same corporation, your holding period for the original stock is added to the holding period for the new stock. Also, if you sell the stock before you've satisfied the five-year holding period, it's possible to preserve the benefits of Sec. 1202 by rolling over your gain into another QSBS within 60 days. The original stock's holding period is added to the replacement stock's holding period. Note that rollover treatment is available only if you held the original stock for more than six months.

Finally, be warned that Sec. 1202 limits the amount of QSBS gain you can exclude with respect to a particular corporate issuer in a given tax year. The maximum exclusion is the *greater* of 1) $10 million or 2) 10 times your aggregate adjusted tax basis in the stock sold during the tax year.

WATCH OUT FOR CORPORATE REDEMPTIONS

When Congress enacted Section 1202 of the tax code (see main article), it was concerned that existing qualified small business stock (QSBS) shareholders would cash in their holdings and then buy new stock with a higher tax basis to take advantage of tax-free gains. To discourage this, Sec. 1202 disqualifies new stock if the company redeems stock from you or a related person within two years before *or after* the new stock is issued. The latter requirement is designed to prevent you from acquiring new stock first and then cashing in the old stock.

Plan carefully

Before investing in QSBS, weigh the benefits against the potential tax costs and investment risks. For example, if you anticipate that the corporation will pay significant dividends, double taxation may erase some of the benefits of tax-free gains.

If you decide to invest in QSBS, monitor your investment to ensure that the stock doesn't become disqualified. This could happen if the corporation ceases to satisfy the active business requirement or redeems your stock. Talk with a financial advisor about managing the risks associated with QSBS and how this investment fits into your larger investment portfolio. ■

3 options if your term life insurance is expiring

A term life insurance policy can be a powerful, cost-effective tool for helping your family meet its financial obligations in the event something happens to you or your spouse. But what happens when the term ends? Here's what you need to know to maintain peace of mind.

Coming to a crossroads

It's common for young couples to buy 20-year (or longer) term life policies when their children are young or they've purchased a home. The idea is that, when a policy reaches the end of its term, children will be financially independent, the mortgage will be largely paid off and the policyholders will have accumulated enough savings.

But that doesn't always turn out to be the case. Children may remain dependent on you well into their 20s, mortgage payments can continue indefinitely (especially if you've refinanced) and retirement savings may fall short of expectations.

Beyond the initial term

If you anticipate that you'll need life insurance protection beyond your policy's initial term, you can take one of several actions:

1. Renew the existing policy. This may be the best option if you have health problems, because many policies allow you to renew without being required to answer health-related questions or undergo a medical exam. However, depending on your age, premiums may increase, especially at the conclusion of a specified level term period.

2. Purchase a new term life policy. If you're in reasonably good health, you may want to purchase a new term life insurance policy. Recent developments in the insurance industry have led to generally lower prices and innovative new products, such as policies that combine life insurance and long-term-care benefits. Some policies offer "living benefits," which allow you to accelerate death benefits in the event of a terminal illness.

To obtain a new policy, you'll need to answer health questions and submit to a medical exam. Premiums will likely be higher than those of your initial policy. But it may be

possible to keep costs down by selecting a shorter term, such as five or 10 vs. 20 years. Another option: If you need coverage for only a few years and can afford sharp price increases, purchase a policy that's renewable annually.

3. Switch to permanent life insurance. If your future financial obligations are uncertain, or you wish to use life insurance to provide a source of wealth for your children or other loved ones, consider permanent life insurance. Whole life, universal life and variable life policies are much more expensive than term life policies, but they provide a death benefit typically for the rest of your life. They also include an investment component that allows you to build cash value on a tax-advantaged basis. Many term life policies allow you to convert to permanent life insurance without a medical exam. And to hold costs down, you may be able to convert your term policy to a permanent policy with lower death benefits.

If you're considering converting to permanent life insurance, review your term life policy as soon as possible. Most policies set a deadline for converting, which may be several years before the term expires.

Covering all the bases

What if you're a young adult who wants to purchase life insurance but doesn't want to have to extend coverage at high prices decades from now? Permanent life insurance would solve the problem, of course. But the premiums may not fit your current budget.

You might consider purchasing a term life policy with a longer term (such as 30 years). Or, you might buy a 20-year term policy with the largest death benefit you can afford, and then supplement it with a 30-year term policy with a smaller death benefit. Ask your insurance agent about this and other cost-effective strategies for protecting your family. ■

A trust can be a mighty financial fortress

You may think of trusts as estate planning tools — vehicles for reducing taxes after your death. While trusts can certainly fill that role, they're also useful for protecting assets, both now and later. Creditors, former business partners, ex-spouses, "spendthrift" children, and taxes can all pose risks. Here's how trusts defend against asset protection challenges.

Tell creditors "hands off"

To protect assets, your trust must own them and be *irrevocable*. This means that you, as the grantor, generally can't modify or terminate the trust after it has been established. (A "revocable trust," on the other hand, allows the grantor to make modifications.) Once you transfer assets into an irrevocable trust, you've effectively removed your rights of ownership to the assets. Because the property is no longer yours, it's unavailable to satisfy claims against you.

It's important to note that placing assets in a trust won't allow you to sidestep responsibility for debts or claims that are outstanding at the time you fund the trust. There may also be a substantial "look-back" period that could eliminate the protection your trust would otherwise provide.

Build a fence

If you're concerned about what will happen to your assets after they pass to the next generation, you may want to consider the defensive features of a "spendthrift" trust. Despite the name, a spendthrift trust does more than protect your heirs from themselves. It can protect your family's assets against dishonest business partners and unscrupulous creditors. It also can protect loved ones in the event of relationship changes. For example, if your son divorces, his spouse generally won't be able to claim a share of the trust property in the divorce settlement.

Several trust types can be designated a spendthrift trust — you just need to add a spendthrift clause to the trust document. Such a clause restricts a beneficiary's ability to assign or transfer his or her interests in the trust, and it restricts the rights of creditors to reach the trust assets. But a spendthrift trust won't defend against claims from your own creditors unless you relinquish any interest in the trust assets. And, depending on applicable law, it's possible for government agencies to reach trust assets so, for example, they can collect on tax obligations.

Trustees play a role in keeping your trust safe. If a trustee is required to make distributions for a beneficiary's support, a court may rule that a creditor can reach trust assets to satisfy support-related debts. So, for increased protection, consider giving your trustee full discretion over whether and when to make distributions. You'll need to balance the potentially competing objectives of having the access you want and preventing creditors and others from having access.

Make asset protection a priority

If securing your assets is a priority — and it should be — talk to your financial advisor about whether a trust can provide the protection you need. There may also be other ways to shelter wealth — for example, maximizing your use of qualified retirement plans. Another option to protect against creditors is to buy an umbrella insurance policy, which provides liability coverage beyond what your auto or homeowners' policies cover. ■

Active vs. passive investing: How the strategies *actually* differ

For years, financial experts have debated the relative merits of active and passive investing. Neither approach is inherently better than the other, and either strategy can outperform depending on market conditions, asset class and other factors.

What's the difference?

Passive (also referred to as "index") funds generally strive to track the performance of a particular market index, such as the S&P 500. Typically, they buy and hold all, or a representative sampling, of the index's securities. Because trading is kept to a minimum, these funds tend to be tax efficient. And their costs are low because they rely on a formula or algorithm rather than labor-intensive analysis of individual companies.

Active funds, in contrast, rely on rigorous analysis to evaluate individual securities and create a portfolio that attempts to beat a market index or achieve other goals. Because these funds often try to maximize profits by selling when investment objectives dictate, they can be less tax efficient. Their need for expert analysts to select securities means that costs generally are higher.

Is the choice really that clear?

It's important to understand that purely passive investing doesn't really exist. Short of buying every security in the world, all investment portfolio choices are "active" to some extent. For example, if you choose the "passive" strategy of investing in an S&P 500 index fund, you've made an *active* decision to limit your investment to U.S. large-cap stocks, a small fraction of the securities available in the United States and across the world.

Passive investing supporters point to studies showing that the majority of actively managed large-cap equity funds underperform their index over the long term. (In part, this is because these funds charge higher expenses.) However, many actively managed funds in other categories, such as bonds and small-cap equities, do beat their indexes. Plus, there's evidence that actively managed funds perform better in certain market conditions.

Who are you?

The right investment strategy depends on who you are — your situation, goals, time horizon and risk tolerance. If you're risk averse and satisfied with matching an index's performance, passive investing may be appropriate. But if you're willing to chance higher volatility because you hope to beat the index, you may be suited for active investing. In many cases, a well-balanced and diversified portfolio will include a combination of passive and active vehicles. Just remember that, with all investment strategies, there's a risk of losing money. ■