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Tax Alpha: Dealing with Heirs

When it comes to leaving an estate for their heirs, many clients are less concerned about protecting it from the taxman than about it protecting it for -- and sometimes from -- the heirs themselves.

"I probably have two conversations a week with HD Vest Advisors who say, "I have a client with $800,000 and they're afraid what's going to happen when their son inherits their assets,'" explained Chad Smith, a wealth management strategist with broker-dealer HD Vest. "The concern may be over the ability and maturity to 'handle' a windfall or inheritance and it is definitely an emotional issue. Other advisors have clients say, 'As soon as my daughter inherits this $800,000, it's going to be gone. What kind of safeguards can we put in place?'"

Smith offered the common scenario of equalizing an inheritance: "Say I have a family farmer in Iowa, and the farmer's son is not a farmer -- he went off to college and became a CPA in Des Moines and owns a firm. But maybe the daughter married someone who's a farmer. If that parent's only asset is a $2 million farm, how does he divide that between his heirs?"

"You have equalization of inheritance issues, you have spendthrift issues, you have dependency issues, and then you have special needs children," Smith explained. These all present wrinkles in client planning -- but many of the solutions also have the benefit of reducing a client's taxable estate.

Many clients would like to see their heirs enjoy parts of their inheritance while the clients are still alive. This usually involves some form of gifting assets to the next generation, which also will reduce a client's taxable estate. It is common to see grandparents create and fund 529 plans for the benefit of their grandchildren. One nice feature about 529 plans is the ability to accelerate up to five years of annual gifting.

Besides that, Smith noted that advisors can help clients by recommending irrevocable trusts. "Instead of giving assets outright to the heirs and loved ones, we give assets to the trust for the benefit of these loved ones," he explained. "One reason we do that is that trusts can have more control." In addition to getting the assets out of the gross estate, this can also keep them out of the hands of heirs who, for whatever reason, may not be able to handle them, without depriving them of the value. Qualified trustees can make sure that spendthrifts don't blow through all their money, or that heirs with special needs are taken care of.

Finally, smart use of trusts and insurance policies can also help with equalization issues, extracting value from assets without requiring liquidation. (And if you're worried about that Iowa farmer, see our 60 Seconds Smarter video, "Equalizing Inheritance," under the Tax Alpha tab above.)