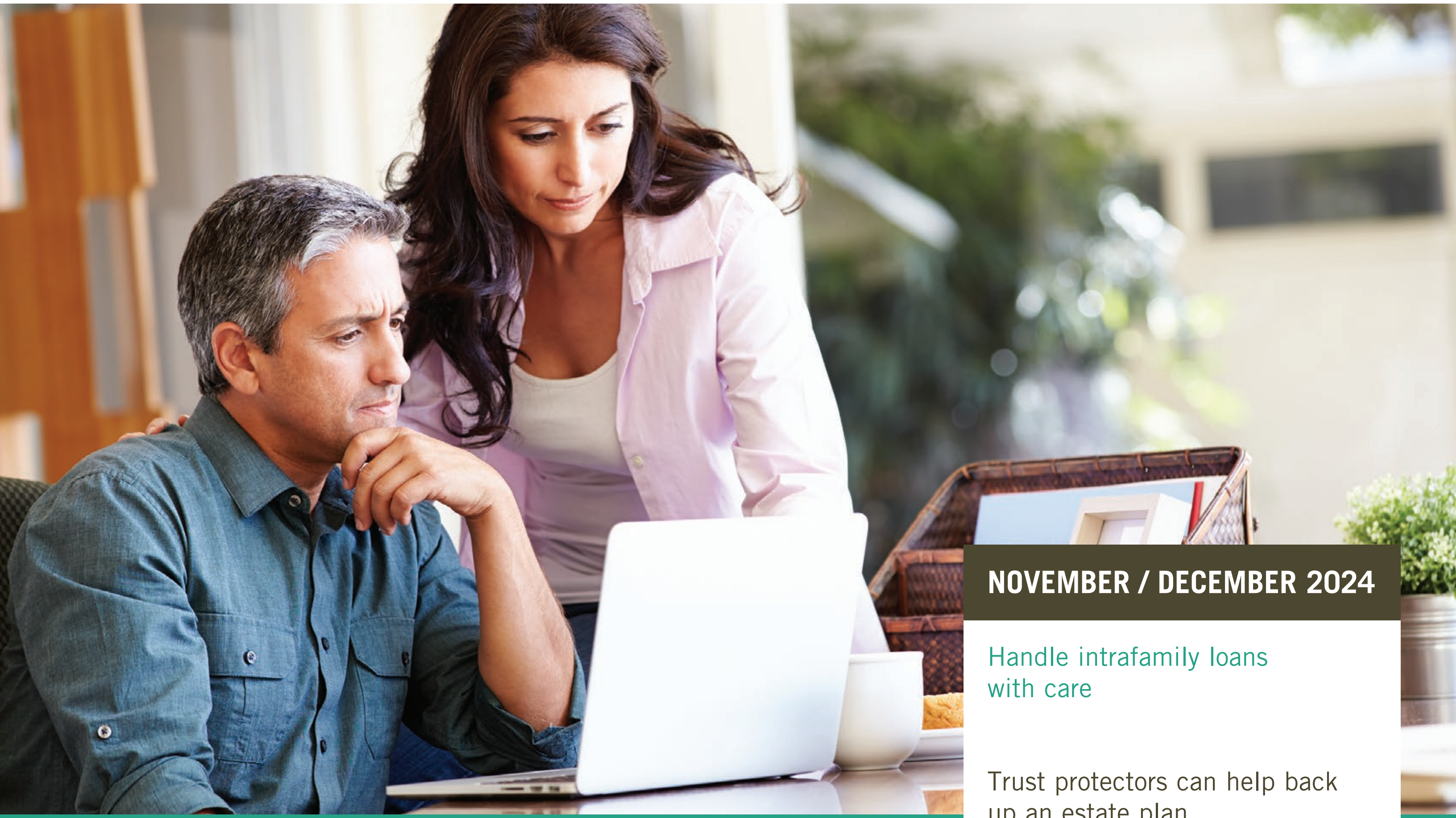
WEALTH MANAGEMENT ADVISOR



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HOW TAX FRAUDSTERS TARGET HIGH-NET-WORTH INDIVIDUALS

How tax fraudsters target high-net-worth individuals

Every year, the IRS compiles its "Dirty Dozen" list of the worst tax scams. Although these scams usually intensify during tax filing season, taxpayers may encounter them anytime. And although tax fraud can nab anyone, certain schemes target those with higher net worth because they have more to steal.

5 scams

Be on the lookout for the following threats:

1. Fake charities. Scammers masquerading as charitable organizations often take advantage of philanthropically inclined individuals who wish to help victims of natural disasters and other tragic events. Fake charities not only steal money intended for legitimate victims, but also gather sensitive personal and financial information about donors to commit tax identity theft. Often, criminals choose names that sound similar to well-known charities and use email or manipulated caller IDs to trick people into making donations.

The IRS advises donors to be wary of pressure tactics, such as time limits. Also:

- Be suspicious of charities that request gift card numbers or wire transfers,
- Pay by credit card or check,
- Never share your Social Security number or other personal or financial information that isn't absolutely necessary, and
- Always take the time to vet charitable organizations with the IRS's Tax-Exempt Organization Search (TEOS) tool.

Only contributions to legitimate, tax-exempt charities qualify for an income tax deduction.

2. Inflated art donation deductions. Beware unscrupulous promoters who promise big deductions for overvalued art. These promoters may encourage you to buy art, often at a "discounted" price, promising that the art is worth significantly more than the purchase price. They may also offer services such as storage, shipping and arranging for appraisal and donation (possibly to a fake charity). Typically, these fraudsters encourage their marks to wait at least a year to donate the art and then claim a tax deduction for the inflated fair market value.

Many art donation deductions are legitimate. But you should be wary of aggressive marketing and promotions and watch out for inflated values or questionable appraisals. The IRS employs a team of professionally trained art appraisers prepared to assess the true value of donated art and flag anything that seems improperly valued.

3. Syndicated conservation easements. A conservation easement is an agreement, usually with a government agency or land trust, to permanently restrict the use of real property. If an easement achieves certain conservation goals — such as protecting natural resources, maintaining the land's scenic or recreational qualities, or preserving historic structures — and meets certain other requirements, the owner generally is entitled to claim a charitable tax deduction based on the easement's value.

The IRS has warned taxpayers of abusive arrangements that could result in audits, penalties and litigation. For example, beware of promoters who, in exchange for high fees, syndicate conservation easement transactions that supposedly allow you to claim charitable contribution deductions that are high in relation to the property's overall value.

4. Offshore schemes. There are some legitimate reasons to house assets outside the United States. However, unscrupulous promoters may attempt to lure you into placing assets in offshore accounts and structures with the promise that they're beyond the IRS's reach. But the IRS has the ability to identify and track anonymous transactions involving foreign financial accounts. If you run afoul of the Foreign Account Tax Compliance Act (FATCA), it could result in serious legal trouble.

5. Digital asset investments. Bad actors may recommend investments in cryptocurrency and nonfungible tokens (NFTs), claiming that such purchases are untraceable and undiscoverable. However, the IRS is hot on their trail. The tax agency says it can find anonymous transactions of digital assets anywhere in the world.

If it seems too good to be true

These are just a few examples of the many tax scams that can ensnare unwitting taxpayers. To protect yourself, work with reputable, trusted tax and investment professionals and always remember that if a tax strategy seems too good to be true, it probably is. ■

WHEN A "FRIEND" IS ACTUALLY A FOE

It's natural for people to trust those who share their ethnicity, religion, workplace, neighborhood, social clubs and other connections. Affinity fraud exploits these commonalities. Perpetrators of such schemes are (or pose as) members of the group they're attempting to defraud.

They may employ Ponzi or pyramid schemes, in which they use money from new investors to pay earlier investors to create the illusion of a successful investment. They also, of course, typically keep a portion of the money themselves. When new investments dry up, such scams generally collapse, leaving later investors with financial losses.

To help avoid becoming a victim of affinity fraud:

- Research every investment offer, including the promotor's background. Know that the person making the pitch could be an innocent front for a criminal.
- Never invest *solely* on the recommendation of someone you know, no matter how well you know the person.
- Don't fall for investments that promise no risk, spectacular profits or "guaranteed" returns.
- Be wary of any transaction that isn't put in writing, particularly if you're told to keep the deal confidential.

Handle intrafamily loans with care

If you want to provide financial assistance to loved ones, you might consider making a loan rather than giving the money with no strings attached. But it's critical to treat any transaction as a bona fide loan. The IRS reviews intrafamily loans and if it determines a loan is or includes a disguised gift, unwelcome tax consequences could follow.

Several advantages

Intrafamily loans offer several advantages over gifts. For one, they allow you to help family members without permanently parting with the money. And they can help instruct your children, grandchildren or other loved ones about financial responsibility.

Also, they may provide estate planning benefits. If borrowed funds produce returns that exceed the interest rate charged for the loan, the borrower essentially receives a tax-free gift.

Withstanding IRS scrutiny

To determine whether a transfer of funds is a loan or gift, the IRS and the courts generally examine several factors. Your transfer is more likely to be considered a loan if:

- The recipient has signed a promissory note,
- You've requested repayment when due (or the amount has already been repaid),
- You charge interest until a maturity date,
- The recipient has provided security or collateral,
- The recipient is likely to have the ability to repay,
- You and the recipient maintain records showing the transaction as a loan, and
- You and the recipient treat the transaction as a loan for federal tax purposes.

The interest rate you charge should be equal to or greater than the applicable federal rate (AFR) published by the IRS for the month you transfer the funds. If it isn't, you may be subject to income tax on "imputed interest," which is the excess of the AFR over the actual interest received. The result is "phantom income," meaning you're taxed on income you never actually receive.

Recharacterization of an intrafamily loan as a gift by the IRS or a court can trigger gift or estate taxes.

Charging adequate interest

Here's an example to illustrate the danger of charging interest below the AFR. Suppose you loan your son Ethan $300,000 for five years with an interest rate of 1.5% at a time when the mid-term (three to nine year) AFR is 5%. At the end of year one, Ethan pays you $4,500 in interest, but you're required to report $15,000 in interest on your tax return.

The difference between the amount of interest you received and the amount you would have received had you charged interest at the AFR — in this example, $10,500 — is phantom income. In addition, the amount of imputed income may be treated as a taxable gift to your son.

Potential consequences

Depending on your net worth, recharacterization of an intrafamily loan as a gift by the IRS or a court can trigger gift or estate taxes. For

2024, the gift and estate tax exemption is $13.61 million (or a combined $27.22 million for married couples). Those amounts are scheduled to be reduced to an estimated $7 million and $14 million, respectively, after 2025. So if you're concerned that outstanding intrafamily loans may be recharacterized as gifts, you might consider forgiving the loans before the end of 2025 to take advantage of the higher exemption amounts.

Suppose, for example, that Heidi has already used up $7 million of her gift and estate tax exemption when she loans $1 million to her daughter Kelsey. Based on the factors listed above, Heidi thinks there's a good chance the IRS will recharacterize the loan as a gift. If the IRS makes that determination after 2025, Heidi may end up with a $400,000 gift tax bill (40% of $1 million). However, if she forgives the debt before the end of 2025, the gift to Kelsey will be tax-free.

Observe formalities

To ensure that an intrafamily loan is treated as such, be sure to observe the formalities associated with bona fide loans. Put it in writing, charge and collect adequate interest, require collateral if appropriate, and otherwise treat the transaction as you would a loan to a nonrelative. ■

Trust protectors can help back up an estate plan

No irrevocable trust is failsafe. Although these instruments typically allow for a hassle-free and tax-advantaged transfer of wealth, there's risk associated with the fact that irrevocable trust founders must give up control of the assets they place in their trusts while they're alive. And they certainly can't control what happens after they die.

Even if you're confident the trustee you've chosen will carry out your wishes, circumstances may intervene. For example, your original trustee could become physically or mentally incapable of handling the responsibility. Some people reduce such risk by naming a trust protector.

Oversight and second opinions

A trust protector is to a trustee what a corporate board of directors is to a CEO. A trustee manages the trust on a day-to-day basis. The protector oversees the trustee and weighs in on critical decisions, such as the sale of closely held business interests or investment transactions involving large dollar amounts.

There's virtually no limit to the powers you can confer on a trust protector. For example, you can enable a trust protector to replace a trustee; appoint a successor trustee or successor trust protector; approve or veto investment or beneficiary distribution decisions; and resolve disputes between trustees and beneficiaries.

However, be careful. It may be tempting to provide a protector with a broad range of powers, but this can hamper your original trustee's ability to manage the trust efficiently. The idea is to protect the integrity of the trust, not to appoint a co-trustee (although that's also an option).

Providing flexibility

Trust protectors can be advantageous when, for instance:

- They're able to remove and replace a trustee who has developed a conflict of interest or failed to manage the trust's assets in the beneficiaries' best interests,
- They can modify the trust's terms to correct trust document errors or clarify ambiguous language, and
- Have the power to change how trust assets are distributed to more effectively achieve your original objectives.

Suppose, for example, that your trust provides that assets will be distributed to your daughter after she graduates from college and lands a paying job. After college, however, your daughter decides to spend two years in the Peace Corps. That decision may not meet the trust's strict definition of "gainfully employed." Even so, your daughter did well academically and has demonstrated an ability to manage money responsibly. If the trust has authorized its

protector to modify its terms, the protector can allow for distributions to your daughter.

Potential abuse of power

Given the power a protector might have over your family's wealth, you'll want to choose someone whom you trust and who's qualified to make investment and other financial decisions. Many people appoint a professional advisor — such as a CPA, attorney, financial planner or investment manager — who may not be able to serve as trustee but can provide an extra layer of protection by monitoring the trustee.

Appointing a family member as protector is also possible but can be risky. If the protector is a beneficiary of your trust or has the power to direct trust assets to him- or herself, this ability could be treated as a general power of appointment. Such a situation potentially could trigger negative tax consequences.

Making the decision

A trust protector isn't essential and, in most circumstances, well-established irrevocable trusts function according to their original owners' intentions without a protector's intervention. But if you do decide to mitigate any lingering risk by naming a protector, work with experienced legal and estate planning advisors to draw up the paperwork that specifies your protector's powers. ■

ETFs or mutual funds: Which is right for you?

Deciding whether to invest in an exchange traded fund (ETF) or mutual fund can be difficult, given their many similarities. But there are also some significant differences between the two fund types.

How they're similar

Both ETFs and mutual funds are professionally managed portfolios of individual stocks, bonds or other types of securities. Both are less risky than direct ownership of securities because funds usually hold hundreds or even thousands of individual securities. If some holdings are performing poorly, it's likely others are performing better.

In addition, both types of funds are professionally managed by experts who select and monitor the investments. Most ETFs (and some mutual funds) are index funds. But even these "passively managed" funds rely on portfolio managers to keep them in line with their target indexes.

How they're different

A big difference between the two fund types is that investors conduct mutual fund transactions with the fund itself. ETFs, as the name suggests, are continuously traded on an exchange similar to a stock. ETFs may be preferable if you're looking for lower investment minimums because you can buy as little as one share. Minimum investments in mutual funds are usually a flat dollar amount (for example, $5,000).

Other differences include:

Price control. ETFs may also be preferable if you're looking for greater purchase and sale price control because they offer real-time pricing and sophisticated ordering options. By contrast, mutual fund prices are updated once a day when the markets close. When you buy mutual fund shares, you pay the same price as every other buyer that day, regardless of what time you place your order.

Automatic investments. If you wish to set up automatic investments or withdrawals, you're usually better off with a mutual fund. ETFs generally don't allow automatic transactions.

Fees. ETFs typically have lower fees. They also tend to be more tax-efficient because they typically generate fewer capital gains while you own them. Investors in ETFs generally realize capital gains only when they sell shares. Mutual fund investors realize capital gains whenever the fund distributes gains. Keep in mind, however, that tax-efficiency isn't an issue if a fund is held in a tax-advantaged retirement account.

More options

Finally, if you're looking for an actively managed portfolio, mutual funds offer many more options. Most ETFs are passively managed, so their investors need to be more hands-on in terms of monitoring their portfolios and making needed adjustments. You may want to discuss these options with your investment advisor. ■