MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

Estate Planning for Generations

This essay was originally published in Muhlenkamp Memorandum *Issue 35, July 1995. It is the first in a series of three that discuss estate planning.*
In this essay, Ron sheds new light on the problem of estate planning by stretching his time horizon. Most estate planners look ahead 30 years (one generation) to develop an estate plan. Ron chooses to look ahead 90 years (three generations) to see the long-term impact of estate planning decisions.

Last quarter, we wrote an essay titled, "Fund Your IRA Every Year, or How to Retire Wealthy by Driving Used Cars." We could have called it "How to Get Started on the Road to Wealth." Once started on that road, there is an ongoing need for intelligent investment management, which is a topic we address in most of our essays. But there is also a need for an intelligent finish, and for the management of assets you have accumulated but are not likely to spend during your lifetime. This endeavor is called estate planning, and I explore this topic in the next few essays.

Any useful estate plan must begin with the goals and priorities that you are trying to accomplish with your accumulated assets. We have found that most of our clients' goals and priorities approximate the following:

1. Provide for client and spouse during their lifetimes.
2. Allow for disasters.
3. Move assets to heirs.
4. Bequeath assets to charities or other organizations.
5. Buy insurance company products.
6. Pay taxes.

Be aware that you do have an estate plan. It was written for you by the U.S. Congress and the legislature of your resident state. But this plan puts taxes as the first priority. Basically it says that when you go to meet your ancestors, these governments will take as taxes 50% of everything you own over

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$600,000. If paying taxes is your first priority, you need no other estate plan. But if you have over $600,000 in assets (including the death benefit on your insurance policy), and you prefer that a greater portion of your assets go to your heirs or to charities, then you need to take positive actions to accomplish it. The earlier you start to do this, the more options you have. (Refer to 2007 Update for current information.)

We have included insurance company products among the priorities listed above, because most of the estate plans we have seen place a high priority on making money for an insurance company, usually moving it to priority number three and often to priority number one.

When I worked for an insurance company 20 years ago, such a priority drove the accepted answers on the Chartered Life Underwriters (CLU) and Fellow, Life Management Institute (FLMI) exams that I took at the time. I am not surprised to see such recommendations from insurance agents. I have been surprised in the past 20 years to see most lawyers, accountants, and financial planners adopt the insurance company's pitch. There is a place for insurance in many estate plans, but most of the plans I have seen misuse insurance—often putting the clients' goals at risk. Insurance plans will be covered in detail in a future newsletter.

At an estate planning seminar that I attended a couple of years ago, one of the speakers said that when he did estate planning he looked ahead 30 years. It occurred to me that 30 years is only one cycle—that is, one generation. Years ago, I was taught that, to begin to understand something, you need to look at more than one cycle, so I constructed the following chart. Figure 6.15 illustrates what happens to your taxable assets (assets in excess of the $600,000 unified credit) under various assumptions.

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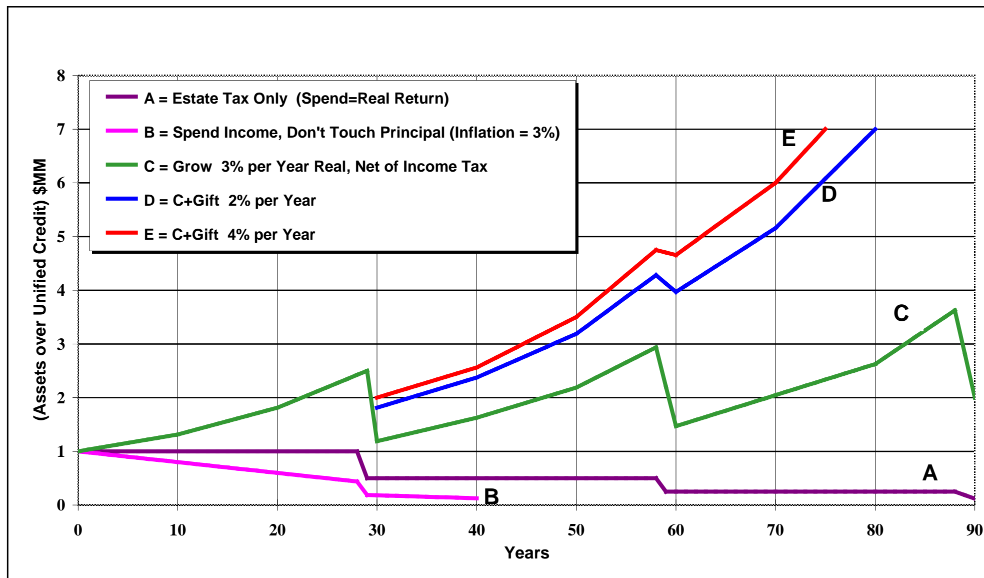
Figure 6.15 Long-Term Financial Planning Overview



Source: Muhlenkamp & Company, Inc.

Line A is the effect of estate taxes alone. Line A assumes that each generation grows the family assets at an after-tax rate that offsets inflation but that estate taxes take 50% of the assets at the end of each generation.

Line B assumes that each generation spends the income but preserves the (nominal) principal and that inflation is 3% per year. A 3% inflation rate cuts the purchasing power of the principal by half in 25 years, and then estate taxes take half of that. The family loses three-quarters of the purchasing power of the assets in one generation. Note that in the past 25 years, inflation averaged 6%, so a family following this "conservative" advice lost 87% of the purchasing power of its assets in one generation.

Line C assumes that the assets grow by 3% per year over inflation, net of income taxes. This allows the assets to double in 25 years, but then estate taxes take half—so the next generation is back to where it started. Knowledgeable investment management makes the difference between Line C and Lines A or B.

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Lines D and E involve gifting strategies to minimize estate taxes, allowing the family's assets to grow over time. To be most effective, these strategies must be in place long before the assets move from one generation to the next. In total, the chart makes plain that both knowledgeable investing and effective estate planning are necessary if your assets are to have much value for your heirs or other beneficiaries.

2007 Update

The argument in this essay remains valid, but the numbers have changed. In 2007, the unified credit is $2 million, not $600,000, and is legislated to change over the next several years. The tax rate will also change over the next several years, but will still be near 50%; (in 2007, the maximum tax is 45%). To get a list of these changes in detail, ask the IRS for a copy of Publication 950.

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