
The New Tax Landscape:
Achieving Maximum Tax Efficiencies and Preparing for
Major Impacts of Proposed and Emerging Legislation

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Wealth Preservation Factors

- Wealth Creation
 - Earnings
 - Investment Return

- Wealth Dilution
 - Spending
 - Income Taxes
 - Estate Tax
 - Inflation
 - Per Capita Dilution

Family Growth Over 3 Generations - 90 Years

| <u>Generation</u> | <u>0 Years 2009</u> | <u>Age</u> | <u>30 Years 2039</u> | <u>Age</u> | <u>60 Years 2069</u> | <u>Age</u> | <u>90 Years 2099</u> | <u>Age</u> |
|--|-----------------------------|------------|------------------------------|------------|------------------------------|------------|------------------------------|------------|
| Parent | 1 | 60 | 1 | 90 | | | | |
| Children | 4 | 30 | 4 | 60 | 4 | 90 | | |
| Grandchildren | 3 | 0 | 12 | 30 | 12 | 60 | 12 | 90 |
| Great GC | 2 | (30) | 24 | 0 | 24 | 30 | 24 | 60 |
| Great-Great GC | 3 | (60) | | (30) | 72 | 0 | 72 | 30 |
| Great-Great-Great GC | 2 | (90) | | (60) | | (30) | 144 | 0 |
| <i>(Spouses Excluded for this purpose)</i> | <u>8</u> | 5.60% | <u>41</u> | 3.41% | <u>112</u> | 2.74% | <u>252</u> | |
| Adult Family Members | <u>5</u> | | <u>16</u> | | <u>36</u> | | <u>96</u> | |

Generational Wealth Growth – Current Rates & No Planning

Assumptions: 8% Investment Return – 2% Spending – 2% Income Tax (25% Average Tax) = 4% Net Growth

| <i>Planning</i> | <i>No</i> | 2009 | | 2039 | | 2069 | | 2099 | |
|-----------------------------------|-------------|----------------|-----------|----------------------|-----------|----------------------|-----------|----------------------|--|
| | | Current Value | | Future Value | | Future Value | | Future Value | |
| Parent's Asset | | \$ 100,000,000 | 4.00% | \$ 324,340,000 | 4.00% | \$ 525,981,000 | 4.00% | \$ 852,983,000 | |
| Less: To Charity | | 100,000,000 | | 324,340,000 | | 525,981,000 | | 852,983,000 | |
| Less: Estate Taxes | 50% | 0 | | (162,170,000) | | (262,991,000) | | (426,492,000) | |
| | | 100,000,000 | | 162,170,000 | | 262,990,000 | | 426,491,000 | |
| Family Dynasty Trust | | 0 | | 0 | | 0 | | 0 | |
| | | 100,000,000 | 1.62% | 162,170,000 | 1.62% | 262,990,000 | 1.62% | 426,491,000 | |
| Value per Adult Descendant | 5 | \$ 20,000,000 | 16 | \$ 10,135,625 | 36 | \$ 7,305,278 | 96 | \$ 4,442,615 | |
| Inflation Adjusted Value | 3.0% | \$ 20,000,000 | | \$ 4,176,000 | | \$ 1,240,000 | | \$ 311,000 | |

Impact of Proposed Changes & Planning on Wealth

| Wealth Growth Factors | | <u>No Changes</u> |
|----------------------------------|-------|-------------------|
| <i>Investment Return</i> | | 8.0% |
| <i>Spending</i> | | -2.0% |
| <i>Average Income Tax Rate</i> | 25.0% | -2.0% |
| | | 4.0% |
| <i>Estate Tax Rate</i> | 50.0% | -2.0% |
| <i>Pre-Inflation Growth</i> | | 2.0% |
| <i>Inflation</i> | | -3.0% |
| <i>Inflation Adjusted Growth</i> | | -1.0% |
| <i>Less: Per Capita Dilution</i> | | ? |
| | | ? |

| | Year | Wealth |
|------------------------------------|-------------|----------------------|
| Current Wealth | 2009 | \$100,000,000 |
| Adult Members/ Inflation Value | 5 | \$20,000,000 |
| After Parents Death | 2039 | \$162,170,000 |
| Adult Members/ Inflation Value | 16 | \$4,176,000 |
| After Children's Death | 2069 | \$262,990,000 |
| Adult Members/ Inflation Value | 36 | \$1,240,000 |
| After Grandchildren's Death | 2099 | \$426,491,000 |
| Adult Members/ Inflation Value | 96 | \$311,000 |

Impact of Proposed Changes & Planning on Wealth

| Wealth Growth Factors | | No Changes | 5% Income Tax Rate Increase |
|----------------------------------|-------|--------------|-----------------------------------|
| <i>Investment Return</i> | | 8.0% | 8.0% |
| <i>Spending</i> | | -2.0% | -2.0% |
| <i>Average Income Tax Rate</i> | 25.0% | -2.0% | -2.4% |
| | | 4.0% | 3.6% |
| <i>Estate Tax Rate</i> | 50.0% | -2.0% | -1.8% |
| <i>Pre-Inflation Growth</i> | | 2.0% | 1.8% |
| <i>Inflation</i> | | -3.0% | -3.0% |
| <i>Inflation Adjusted Growth</i> | | -1.0% | -1.2% |
| <i>Less: Per Capita Dilution</i> | | ? | ? |
| | | ? | ? |

| | Year | Wealth | | Wealth |
|------------------------------------|-------------|----------------------|-------------|----------------------|
| Current Wealth | 2009 | \$100,000,000 | | \$100,000,000 |
| Adult Members/ Inflation Value | 5 | \$20,000,000 | | \$20,000,000 |
| After Parents Death | 2039 | \$162,170,000 | -11% | \$144,465,000 |
| Adult Members/ Inflation Value | 16 | \$4,176,000 | | \$3,720,000 |
| After Children's Death | 2069 | \$262,990,000 | -21% | \$208,702,000 |
| Adult Members/ Inflation Value | 36 | \$1,240,000 | | \$984,000 |
| After Grandchildren's Death | 2099 | \$426,491,000 | -29% | \$301,501,000 |
| Adult Members/ Inflation Value | 96 | \$311,000 | | \$220,000 |

Impact of Proposed Changes & Planning on Wealth

| Wealth Growth Factors | | No Changes | 5% Income Tax Rate Increase | Planning Sale to Dynasty Trust |
|----------------------------------|-------|--------------|-----------------------------------|--------------------------------------|
| <i>Investment Return</i> | | 8.0% | 8.0% | 8.0% |
| <i>Spending</i> | | -2.0% | -2.0% | -2.0% |
| <i>Average Income Tax Rate</i> | 25.0% | -2.0% | -2.4% | -2.4% |
| | | 4.0% | 3.6% | 3.6% |
| <i>Estate Tax Rate</i> | 50.0% | -2.0% | -1.8% | -1.8% |
| <i>Pre-Inflation Growth</i> | | 2.0% | 1.8% | 1.8% |
| <i>Inflation</i> | | -3.0% | -3.0% | -3.0% |
| <i>Inflation Adjusted Growth</i> | | -1.0% | -1.2% | -1.2% |
| <i>Less: Per Capita Dilution</i> | | ? | ? | ? |
| | | ? | ? | ? |

| | Year | Wealth | | Wealth | | Wealth |
|------------------------------------|-------------|----------------------|------|----------------------|------|------------------------|
| Current Wealth | 2009 | \$100,000,000 | | \$100,000,000 | | \$100,000,000 |
| Adult Members/ Inflation Value | 5 | \$20,000,000 | | \$20,000,000 | | \$20,000,000 |
| After Parents Death | 2039 | \$162,170,000 | -11% | \$144,465,000 | 44% | \$232,859,000 |
| Adult Members/ Inflation Value | 16 | \$4,176,000 | | \$3,720,000 | | \$5,996,000 |
| After Children's Death | 2069 | \$262,990,000 | -21% | \$208,702,000 | 156% | \$672,801,000 |
| Adult Members/ Inflation Value | 36 | \$1,240,000 | | \$984,000 | | \$3,172,000 |
| After Grandchildren's Death | 2099 | \$426,491,000 | -29% | \$301,501,000 | 356% | \$1,943,923,000 |
| Adult Members/ Inflation Value | 96 | \$311,000 | | \$220,000 | | \$1,416,000 |

Generational Wealth Growth – 5% Tax Increase & Dynasty Trust Planning

Assumptions: 8% Investment Return – 2% Spending – 2.4% Income Tax (30% Average Tax) = 4% Net Growth

Dynasty Trust Planning: \$1.9 million gift & \$16.9 million FLP Sale (2.25% interest) (Net of 25% Discount)

| <i>Planning</i> | Yes | 2009 | | 2039 | | 2069 | | 2099 | |
|-----------------------------------|-------------|---------------|-----------|----------------|-----------|---------------|-----------|---------------|--|
| | | Current Value | | Future Value | | Future Value | | Future Value | |
| Parent's Asset | | \$ 91,875,000 | 0.67% | \$ 112,141,000 | -100.00% | \$ - | 0.00% | \$ - | |
| Less: To Charity | | | | | | | | | |
| | | 91,875,000 | | 112,141,000 | | 0 | | 0 | |
| Less: Estate Taxes | 50% | 0 | | (56,071,000) | | 0 | | 0 | |
| | | 91,875,000 | | 56,070,000 | | 0 | | 0 | |
| Family Dynasty Trust | | 8,125,000 | 10.81% | 176,789,000 | 4.56% | 672,801,000 | 3.60% | 1,943,923,000 | |
| | | 100,000,000 | 2.86% | 232,859,000 | 3.60% | 672,801,000 | 3.60% | 1,943,923,000 | |
| Value per Adult Descendant | 5 | \$ 20,000,000 | 16 | \$ 14,553,688 | 36 | \$ 18,688,917 | 96 | \$ 20,249,198 | |
| Inflation Adjusted Value | 3.0% | \$ 20,000,000 | | \$ 5,996,000 | | \$ 3,172,000 | | \$ 1,416,000 | |

Obama Budget: Proposed Legislation

Administration's Income Tax Rate Proposals – High Income Joint Returns

| Taxable Income | Before 2002 | Current (EGTRRA) | Administration |
|------------------------------------|-------------------------|-----------------------------|----------------------------------|
| LT Capital Gains: Regular & AMT | 20% | 15% Sunsets 2010 | 20% Effective 2011 |
| Qualified Dividends | 39.6% | 15% Sunsets 2010 | 20% Effective 2011 |
| Ordinary Income | 39.6% Over \$349,700 | 35% Over \$372,950 | *Top rate reverts to 39.6% |
| AMT Ordinary Income | 28% | 28% | 28% |
| C Corporations | 35% | 35% | 35% |

* 36% over \$250,000 less standard deduction and 2 personal exemptions

Impact of Proposed Rate Change on Family Business Entities

- C Corporation: Double Taxation
 - Tax on earnings: Corporate tax of 35%
 - Shareholder Tax: Individuals would pay 20% tax on any dividend income or capital gain on sale of stock
 - **Total effective tax rate of 48%**
- Flow Thru Entities: S Corporations & Partnerships/LLCs
 - Tax on earnings: No entity tax but individual owners would pay 39.6% tax
 - With rate increase, flow thru structures would pay 4.6% more tax on its earnings
 - Shareholder Tax: Distribution of earnings is tax free and reduced capital gain tax on sale of equity
 - *8.4% savings if double tax applies*
 - *Potential increased sales value of 20 to 25% of Goodwill on sale due to buyer tax benefits*
 - *Allows buyer to write-off purchase price for tax purposes.*

Planning for Proposed Increased Tax Rates

- Decreased AMT: 39.6% vs 28% AMT Rate
- Special Tax Sensitive Investments
 - Rate increase could have significant impact on municipal bond investments and dividend paying stocks
- Accelerate Ordinary Income or Defer Deductions?
 - 5% permanent savings but time value of money cost
 - Breakeven utilizing a 6% discount rate is about 2 years
 - Example: Accelerate \$100 of income payable in 2012 to 2010
 - 2012 tax at 39.6% would be \$39.60
 - The present value of this tax in year 2010 would be \$35.24 compared to \$35 tax in year 2010
- NOL: Carryback or Carryover?
 - Effective tax rate and AMT considerations
- 20% Capital Gain Rate
 - 5% permanent savings if gain recognized before effective date
 - Time value of money breakeven is about 5 years with a 6% discount rate
 - Installment sale effective date – previous changes when gain recognized.

Reductions in Itemized Deductions

■ **Current Law**

- Include medical and dental (in excess of 7.5% of AGI), state and local property taxes, income/sales taxes, interest paid, charitable contributions, casualty/theft losses (in excess of 10% of AGI), job expenses, and other miscellaneous (some in excess of 2% of AGI)
- 2009 – otherwise allowable itemized deductions (not including casualty/theft losses, medical expenses, investment interest, and gambling losses) are reduced by 1% of AGI over the threshold (statutory floor indexed annually for inflation) but not by more than 26 2/3%
- Reduction to be eliminated in 2010
- 3% reduction (not by more than 80%) to be reinstated in 2011
- 2009 – AGI floor is \$166,800 (married filing jointly) and \$83,400 (married filing separately)

■ **Proposed Change** (*Effective 2011*)

- Otherwise allowable deductions (excluding casualty/theft losses, medical expense, investment interest, and gambling losses) will be reduced by 3% of the amount exceeding the statutory floors, but not by more than 80% of otherwise allowable deductions
- Floors are annually indexed for inflation
- 2011 – AGI floors would be adjusted for inflation starting at \$250,000 in 2009 for married filing jointly and \$200,000 for 2009 single taxpayers

Personal Exemption Phase-Out

■ **Current Law**

- Personal Exemption - \$3,650 for 2009; indexed annually for inflation
- 2009 – personal exemptions reduced by 2/3 of a percentage point for each \$2,500 (married filing jointly) and \$1,250 (married filing separately) or fraction thereof by which AGI exceeds the threshold, but not by more than 1/3 of the unreduced exemption amount
- 2009 thresholds – \$250,200 (married filing jointly); \$125,100 (married filing separately); \$166,800 (single)
- Highest income taxpayers entitled to \$2,433.33 personal exemption

■ **Proposed Change** (*Effective 2011*)

- Elimination of the personal exemption phase-out would sunset after 2010
- 2011 AGI floors would be adjusted for inflation starting at \$250,000 in 2009 (married filing jointly), \$125,000 (married filing separately) and \$200,000 (single)

Capital Gains on Qualified Small Business Stock

■ Current Law

- Taxpayers (excludes corporations) may exclude 50 percent of the eligible gain of sale of certain small business stock, acquired at original issue from the corporation and held at least 5 years
- Exclusion increased to 75% for stock acquired in 2009 and in 2010
- Taxable portion is taxed at a maximum rate of 28%
 - 7% of the excluded gain is a preference item for AMT (scheduled to increase to 28% for eligible stock acquired after December 31, 2000 and 42% for stock acquired before that date)
- Amount of eligible gain for exclusion is the greater of:
 - 10 times the taxpayer's basis in stock issued by the corporation and disposed of during the year, or
 - \$10M reduced by gain excluded in prior years on disposition of the corporation's stock
- **Small business:** Corporation's gross assets cannot exceed \$50 million when stock is issued (includes stock), **cannot be an S-Corp**, and corporation must meet certain active business requirements

■ Proposed Change *(Effective for QSBS issued after February 17, 2009)*

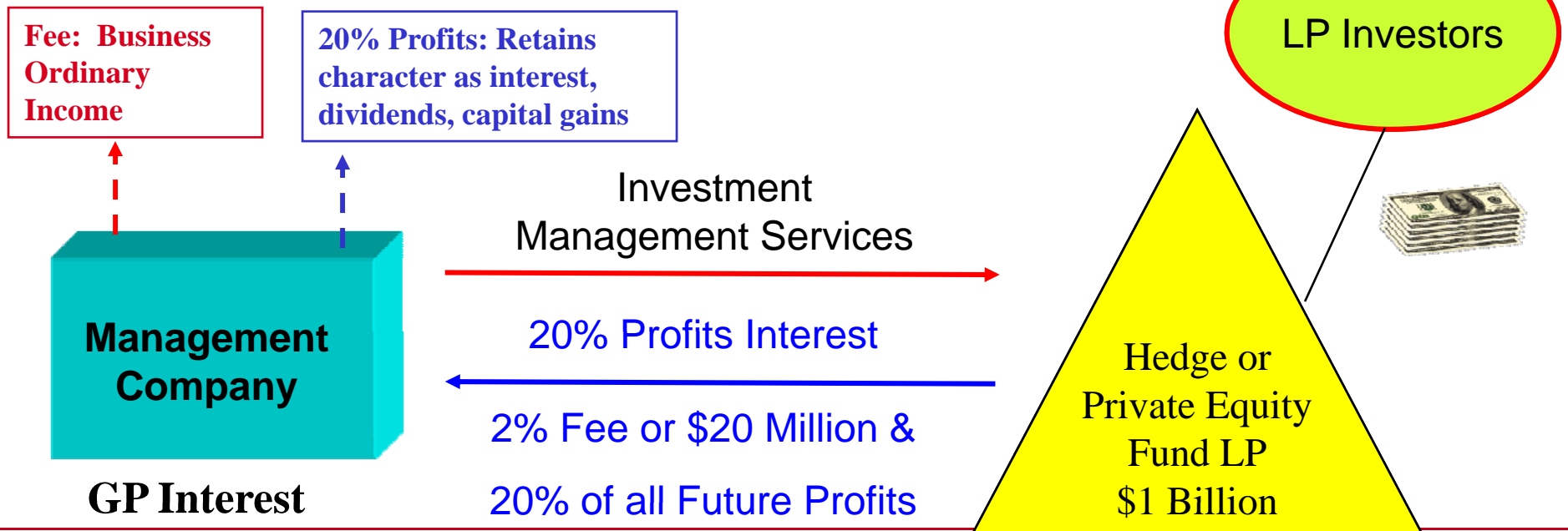
- Percentage exclusion for qualified small business stock would be increased to 100%
- AMT preference item for excluded gain would be eliminated
- Stock would have to be held at least 5 years and satisfy other §1202 provisions
- Additional documentation requirements to assure compliance with statute (requirements not listed)

■ **Benefit Example:** \$10 million eligible gain @ 20% = \$2 million plus state

Partnership Profits Interest Received For Services

- Manager or Service Provider receives a “Profits” or “Carried Interest” in a partnership or LLC in exchange for management services, e.g., Private Equity, Hedge Fund, or Real Estate Manager.
- If there is risk as to whether a profit will be earned and the interest is not disposed of within 2 years, the receipt of the profits interest is generally not subject to immediate taxation. (*See Rev. Proc. 93-27 for other requirements*).
- Allocated partnership income to the Manager retains its character as interest, dividend or capital gains rather than treated as compensation for services.

Managers



Proposal: Recharacterize Profits Interest Gains, etc. as Ordinary Income

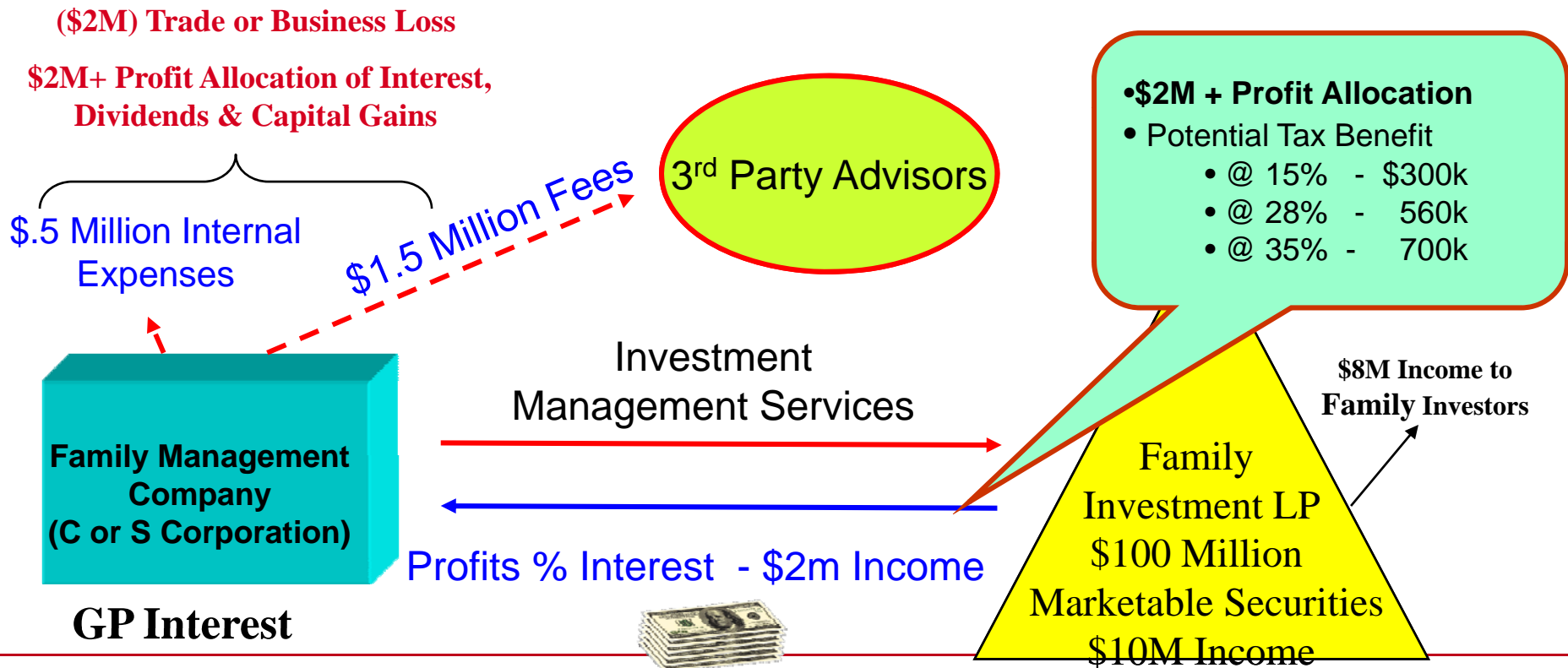
- Allocated Profits Interest Income Items Treated as Ordinary Compensation Income
 - Partner's share of income on a SPI (services partnership interest) would be taxed as ordinary income, regardless of how it is characterized at the partnership level.
 - Income would be subject to self-employment tax
 - If the Service Partner also has "Invested Capital", then the partnership must reasonably allocate income between invested capital and the services interest.
 - "Invested Capital" – money or other property contributed to the partnership
 - *The proposal does not address whether the allocated income would be treated as a deduction to the other partners. If so, increased income allocation with possibly a non-deductible expense.*
- Gains from Derivatives & Other "Disqualified Interests" Treated as Ordinary
 - A person who performs services for an entity and holds a "disqualified interest" in the entity is subject to ordinary income tax on any gain received with respect to the disqualified interest
 - "Disqualified Interest" – convertible or contingent debt, an option, or any derivative instrument with respect to the entity, but does not include a partnership interest or stock in certain taxable corporations
- *Effective for taxable years beginning after December 31, 2010*

Increasing Investment Expenses & Decreasing Tax Benefits

- Sale of Business for Significant Cash Proceeds –Typical Reinvestment Strategy
 - Marketable Securities – **Related Expenses are Sec. 212 Investment**
 - Private Equity - **Related Expenses are Sec. 212 Investment**
 - Real Estate - **Related Expenses are Sec. 162 Trade or Business**
- Families without Significant Ordinary Income
 - Most income is 15% dividend income and capital gains (Good tax result)
 - Sec. 212 Investment expenses are not deductible for AMT purposes
 - *Most of these families pay AMT with little or no tax benefit of their investment expenses.*
- Families with Investment Expenses & Significant Business Ordinary Income
 - Successful business held in an S Corporation or LLC generates significant ordinary income to family.
 - Investment expenses are phased-out under the 2% AGI rule of Sec. 67

Family Investment Partnership with Profits Interest

- The Family Office Entity becomes the general partner of the Family Investment partnership and provides investment management business services to the partnership in exchange for a profits interest in the Family Investment LP
- As the investment manager, the Family Office pays all of the investment advisory expenses related to the management of the partnership's investments.



Family Office - Utilization of Profits Interest Structure

- Family Office Receives Profits Interest for Investment Management Services
 - Family office incurs salaries and third party expenses to manage Investment Partnership assets and deducts expenses as business expenses
 - Partnership allocates a portion of the investment profits to the Family Office consisting of interest, dividends and capital gains
 - The other family members have reduced investment income and no investment expenses to be disallowed.
- Impact of Proposed Legislation and Underperforming Returns
 - Ordinary income treatment reduces tax benefit of managers structured as a flow-thru
 - If recharacterization creates more income and an offsetting investment expense to the investors, than the entire benefit is eliminated.
 - Due to the Investment Losses incurred during 2008, many Profits Interests are underwater and may need to be restructured.

Key Elements of Profits Interest Structure

- Management Corporation must be in a trade or business
 - Must be *for profit*
 - Must be a continuous activity
 - Must be managing investments for *others* - In *Higgins (1941)*, Supreme Court held that a person cannot be in a trade or business of managing his own investments.
 - Issue: Are the owners of the investment partnership and the manager the same?
- Management Corporation must receive a profits interest, not a guaranteed payment or a disguised fee under Section 707. Senate Report to Section 707 list 5 factors:
 - **Entrepreneurial risk** – i.e., appreciable risk of amount of profit?
 - Example: 20% of all profits versus 100% of first \$2 million of income
 - Whether the partner status is transitory
 - Proximity in time of services to the allocation and distribution of profit
 - Primary purpose of partnership interest is to gain a tax benefit
 - Is the value of the GP's interest small compared to the allocation

Investment Partnership Profits Interest Summary

| | Manager | Investment Partnership |
|--|---|---|
| Profit Interest in Investment Partnership | <ul style="list-style-type: none"> ▪ Allocated income retains character as interest, dividends & capital gains. | <ul style="list-style-type: none"> ▪ Reduced investment income to investors – no deduction subject to disallowance. |
| Income Tax Issues | <ul style="list-style-type: none"> ▪ Trade or business required <ul style="list-style-type: none"> ➤ Cannot manage own investment assets ➤ Profit motive ▪ C Corp – double tax & PHC | <ul style="list-style-type: none"> ▪ Profit allocation vs disguised fee <ul style="list-style-type: none"> ➤ Must have entrepreneurial risk ➤ Appreciable risk as to amount ➤ Not a guaranteed fee |
| Gift & Estate | <ul style="list-style-type: none"> ▪ Reverse estate planning risk if parents own Manager and younger generation trusts have capital interest in Investment Partnership | <ul style="list-style-type: none"> ▪ Sec. 2701 Gift Risk – If younger generation owns Manager, then risk parent’s capital treated as a gift to the extent of the younger generation’s profit percentage. |

Gift & Estate Tax

Administration's Estate Tax Proposals

| | Before 2002 | Current (EGTRRA) | Obama |
|--|---|---|---|
| Maximum Federal Estate & GST Tax Rate | 50% | 2009: 45% 2010: Repealed 2011: Reverts to 2001 | 45% |
| Gift Exemption | \$1 million | \$1 million | Some discussion to increase to \$3.5 million |
| Estate & GST Exemption Amount | \$1 million | 2008: \$2 million 2009: \$3.5 million | \$3.5 million |
| Illinois Inheritance Tax | Up to 16% Reduced Federal Tax \$1:1 - Credit | Up to 16% Treated as a Federal Deduction: \$1 to .45 | Same as current |

Estate Tax Planning Drivers

- Reduce existing value via:
 - Discounts of minority interest held in family business or Family Investment Partnership – Individual vs family ownership
 - Grantor Trust: Parent pays income tax on Family Trust income
- Time value of money
 - Most significant part of planning
 - Freeze techniques: Shift highly appreciating assets to Family Trust utilizing gifts and low interest rate leverage techniques
- Opportunistic Time for Estate Planning
 - Current low valuations increase potential growth rate
 - Historic low safe-harbor IRS interest and GRAT rates enhance freeze



Family Partnership – Valuation Discounts

| Case Name & Cite | Percentage Discount Allowed |
|---|---------------------------------|
| <u>McCord, Jr. v. Comm’r</u> , 461 F.3d 614 (2006) | 25% |
| <u>Estate of Miller, et al.</u> , TC Memo 2009-119 | 35% |
| <u>Gross</u> , TC Memo 2008-221 | 35% |
| <u>Estate of Kelly, et. al.</u> TC Memo 2005-235 | 35% - Note: Court determined |

Gift & Estate Planning Freeze Techniques

- There are several transactions ranging from the simple to the more complex which can be aided by a down market and include:
 - Outright Gifts
 - GRATS
 - Intra-Family Loans
 - Installment Sales to Grantor Trusts
 - Dynasty or Generation Skipping Transfer Tax (GST) Trusts
 - Late GST Allocations for 2008 gifts that have decreased in value
 - Private Annuities
 - SCINS (Self Cancelling Installment Notes)
 - CLATS (Charitable Lead Annuity Trusts)
 - QPRTS (Qualified Personal Residence Trusts)

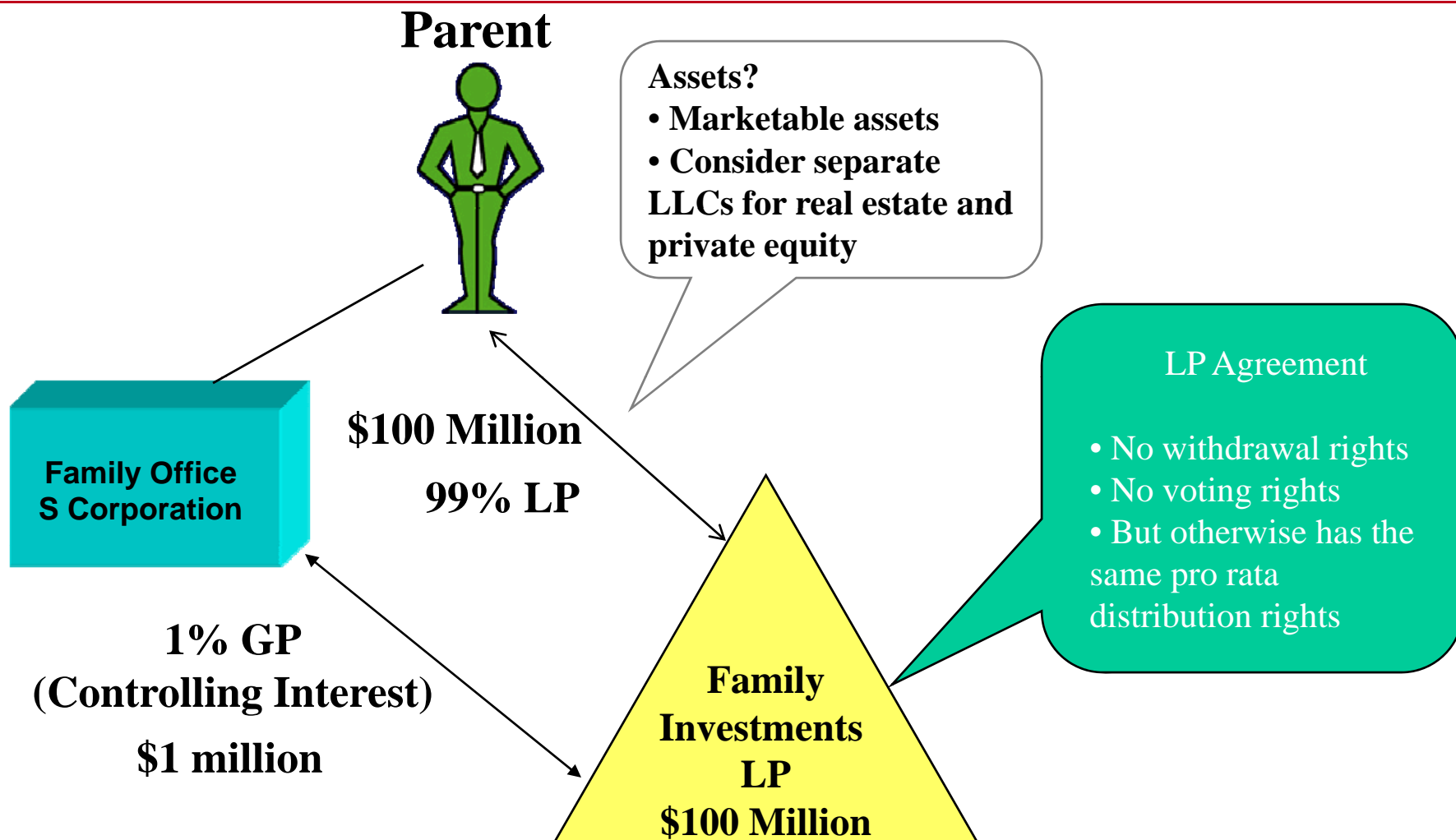
Freeze Techniques: Transfer Value to Dynasty Trust

| Technique | Assumed Investment Return | Fixed Return to Older Generation (June 2009) | Excess Return To Dynasty Tr. |
|------------------------------|----------------------------------|--|--|
| Installment Sale | 8% | IRS Safe Harbor Rates: .75% < 3 Yrs 2.25% ≤ 9 Yrs 3.88% > 9 Yrs | Excess Returns: 7.25% < 3 Yrs 5.75% < 9 Yrs 4.12% ≥ 9 Yrs |
| Preferred Partnership | 8% | Preferred Return = Market Rate? | ? |
| GRAT (Annuity Trust) | 8% | 2.8% IRS Safe Harbor Rate on Fixed Annuity | 5.2% |

Current Economic Conditions



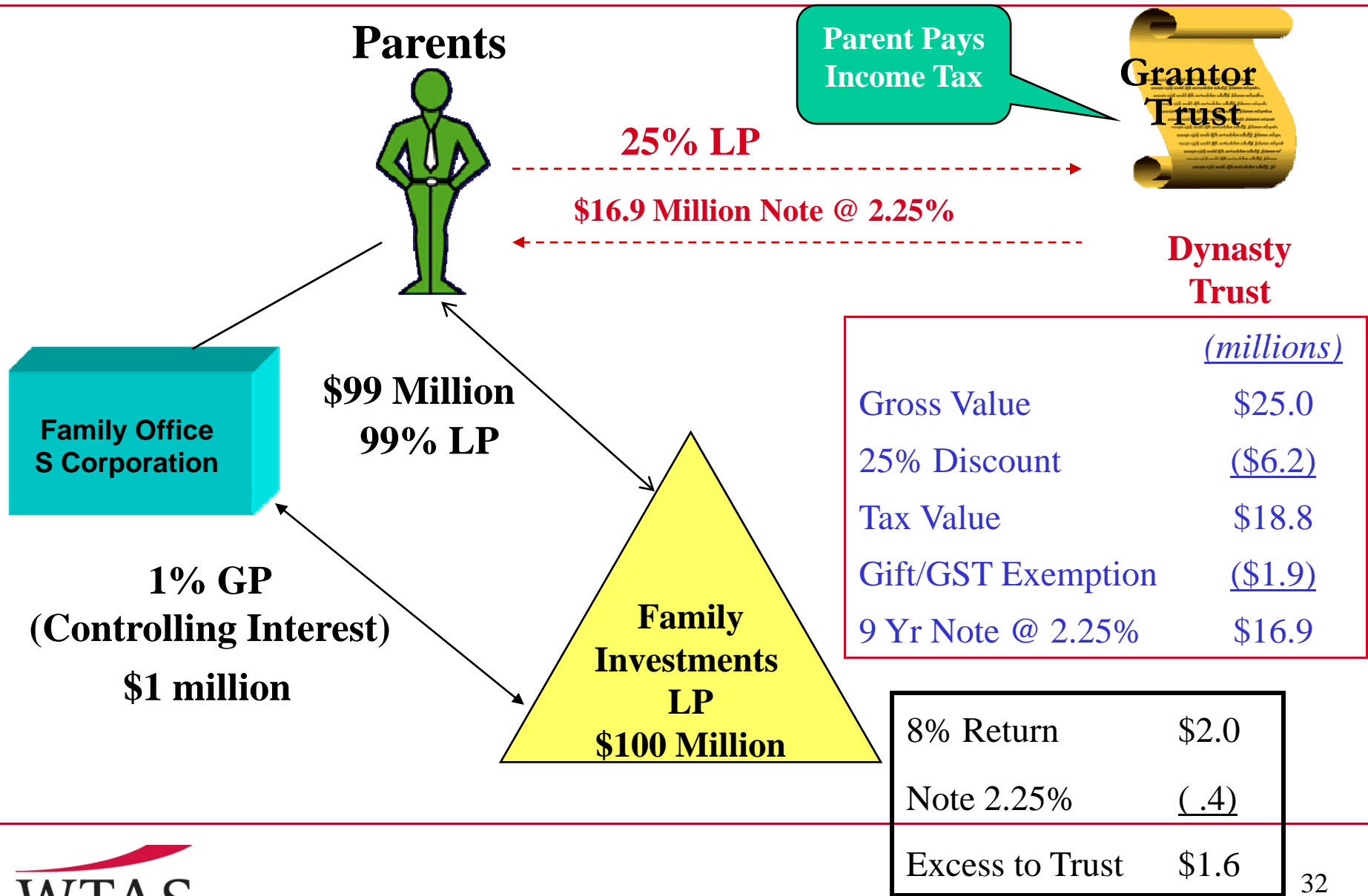
Investment Partnership Formation



Issues on Formation of Family Investment Partnership

- Type of Entity: LLC or Limited Partnership?
- Partnership Agreement
 - Restricted withdrawal and transfer rights
- SEC/Accredited Investors
- Investment Partnership – Contribution of appreciated assets may trigger gain under Section 721 if diversification occurs
- Provide sufficient time after formation to effect titling of assets
- All transfers to the FLP must be for full and adequate consideration in money or money's worth
 - IRS has raised and lost on the issue of indirect gift upon formation.
- Retaining too much control over FLP or an implied agreement to retain income can cause estate inclusion at death.

Gift & Installment Sale to Dynasty Trust



Installment Sales to Grantor Trusts – (Continued)

| <u>Year</u> | <u>Beginning Asset Value</u> | <u>Effective Yield</u> | <u>Income & Appreciation</u> | <u>EOY Interest Debt Service</u> | <u>30% Tax</u> | <u>Ending Asset Value</u> | <u>Ending Debt Balance</u> | <u>Equity Value</u> |
|-------------|------------------------------|------------------------|----------------------------------|----------------------------------|----------------|---------------------------|----------------------------|---------------------|
| 0 | 25,000,000 | | | | | 25,000,000 | (16,875,000) | 8,125,000 |
| 1 | 25,000,000 | 8.0% | 2,000,000 | (379,688) | 0 | 26,620,313 | (16,875,000) | 9,745,313 |
| 2 | 26,620,313 | 8.0% | 2,129,625 | (379,688) | 0 | 28,370,250 | (16,875,000) | 11,495,250 |
| 3 | 28,370,250 | 8.0% | 2,269,620 | (379,688) | 0 | 30,260,183 | (16,875,000) | 13,385,183 |
| 4 | 30,260,183 | 8.0% | 2,420,815 | (379,688) | 0 | 32,301,310 | (16,875,000) | 15,426,310 |
| 5 | 32,301,310 | 8.0% | 2,584,105 | (379,688) | 0 | 34,505,727 | (16,875,000) | 17,630,727 |
| 6 | 34,505,727 | 8.0% | 2,760,458 | (379,688) | 0 | 36,886,498 | (16,875,000) | 20,011,498 |
| 7 | 36,886,498 | 8.0% | 2,950,920 | (379,688) | 0 | 39,457,730 | (16,875,000) | 22,582,730 |
| 8 | 39,457,730 | 8.0% | 3,156,618 | (379,688) | 0 | 42,234,661 | (16,875,000) | 25,359,661 |
| 9 | 42,234,661 | 8.0% | 3,378,773 | (379,688) | 0 | 45,233,746 | (16,875,000) | 28,358,746 |
| 10 | 45,233,746 | 8.0% | 3,618,700 | (675,000) | 0 | 48,177,446 | (16,875,000) | 31,302,446 |

What is a Dynasty Trust?

- Trustee holds assets for benefit of children and all future descendants
- Trust provides creditor and estate tax protection for descendants
- Trust may continue indefinitely with ability for each generation to rewrite terms
- Trust makes discretionary distributions to children for support and remaining assets are retained in the trust for future generations
- Typical provisions cause the trust to be treated as a Grantor Trust
 - Parent as grantor will pay tax on all income earned by the trust without cash reimbursement
- Parent should allocate sufficient Generation Skipping Transfer Tax (GST) exemption to the trust to avoid GST Tax on future distributions to grandchildren and other descendants.



Tax Considerations of Sale

- Valuation Gift Tax Risk
 - Parent will be treated as making a gift to the Trust if the partnership interest is sold below fair market value.
 - Debt must be structured and respected as true debt rather than equity to avoid imputed gift under Chapter 14.
 - Sufficient equity in Dynasty Trust
 - Potential impact on formula GST exemption allocation and status as a GST exempt trust.
- Gift Tax Return
 - Disclosure of sale is required to start the statute of limitations for any gift
 - Protective GST exemption allocation
- New Estate Tax Return Disclosure of Sale to Trust
 - If sold to a trust created by seller
 - If sold to a trust in which the seller holds any power, beneficial interest, or is a trustee
- Income Tax Considerations
 - Not treated as a sale for income tax purposes assuming the Dynasty Trust is a Grantor Trust with respect to the selling Parent
 - Termination of Parent's Grantor Trust Status – Potential gain to the extent liabilities exceed basis

Valuation Discounts – Current Code Section 2704

- Current Law: Discounts Typically Allowed to Reduce Value of a Family Controlled Business or Investment Partnership
 - Lack of Marketability: discount when less than 100% owned and no public market or right to liquidate.
 - Minority Interest: When the interest does not have voting control or entitle the owner to a swing vote.
 - *Family Attribution?: In determining whether an individual family member qualifies for a discount, should the family’s overall voting control or liquidation rights be considered? Courts generally NO but section 2704 limited yes.*
- § 2704: “Applicable Restrictions” are ignored in family controlled entities
 - Certain lapsing voting or liquidation rights treated as a transfer of value equal to the discount created by the lapse if the family controls the entity.
 - Applicable Restrictions, for example, a restriction preventing a partner from withdrawing from a family partnership, is ignored for valuation purposes if the restriction is more restrictive than state law.
 - Today, most state partnership and LLC default provisions provide that a partner cannot withdraw unless the agreement is drafted to allow withdrawal.
 - Family Investment Partnerships are drafted not to allow withdrawal and thus qualify for a discount because the no withdrawal restriction is not more restrictive than the default provisions under state law.

Proposed Valuation Discount Changes – Revised Section 2704

- Disregarded Restrictions Ignored
 - An additional category of restrictions (“*disregarded restrictions*”) would be created. These restrictions would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after a transfer, the restriction will lapse or *may be removed by the transferor and/or the transferor’s family*.
- Disregarded Restrictions include:
 - Limitation on holder’s right of liquidation that are *more restrictive than the standard to be identified in regulations*.
 - Limitation on transferee’s ability to be admitted as full partner in entity for purposes of determining whether a restriction may be removed by members of the family, certain interests (to be identified in regulations) held by charities or other non-family members will be deemed to be held by the family.
- Valuation: Transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations
- Effective Date: *Applies to transfers after date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of 2704)*

GRATs: Proposed 10 Year Minimum Term

- Grantor Retained Annuity Trust (GRAT) - Current Law:
 - **In General:** A GRAT is an irrevocable trust that pays the Grantor a fixed annuity for a term of years. After the annuity term expires, any remaining trust assets would be distributed to or held in trust for the benefit of family members usually children. Grantor cannot allocate GST exemption until the end of the GRAT term.
 - **Benefit:** The Grantor will transfer investment assets to the GRAT. The GRAT will build a remainder value distributable to the designated beneficiaries if the earnings and appreciation of the GRAT property exceeds the IRS Section 7520 rate, which is 2.8% for GRATs created in June 2009. The GRAT is a grantor trust for income tax purposes.
 - **“No Gift” Gift:** The value of the remainder interest is the fair market value of the property transferred less the present value of the retained annuity utilizing the Section 7520 rate. Typically, the GRAT is structured to have a zero value creating a 100% leveraged freeze. *The annuity will increase automatically if IRS successfully asserts a higher value for the property transferred.*
 - **Mortality Risk:** If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor’s gross estate and the estate tax benefit of creating a GRAT is reduced or eliminated.
 - **Rolling 2 Year GRATs:** Many taxpayers utilize a 2 year GRAT term rolling over the Grantor’s annuity payments to a new 2 Year GRAT to mitigate the mortality risk
- Proposed 10 Year Minimum Term for GRAT
 - The 10 year minimum term increases the mortality risk
 - Can continue to structure as a “zeroed out” or “no gift” GRAT
 - Effective for trusts created after the date of enactment

Late GST Allocations

- Ordinarily, a late GST allocation is a negative event due to asset appreciation. In a down market, the opposite may be true.
- The amount of GST exemption allocation required to exempt a gift to a trust, made in a timely fashion, equals the value of the gift on the transfer date (or if the result of an automatic allocation under sec. 2632(b)).
- The amount of GST exemption allocation required to exempt a gift to a trust, not made in a timely fashion, equals the value of the assets transferred on the date the allocation is actually made on late filed gift tax return. If the value of an asset transferred to a trust has decreased from the time of transfer and a GST allocation is desired, consider making a late allocation.
- Example – On January 15th 2008 stock valued at 50,000 is gifted to a trust. On June 1st 2009 the stock is worth 25,000. If a GST allocation is made on a timely filed gift tax return, the exemption used will be \$50,000. If a late allocation is made during June, the exemption used will be \$25,000.

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