CURRENT WEALTH TRANSFER STRATEGIES UNDER THE TAX RELIEF ACT OF 2010 AND THE UNCERTAINTIES CREATED BY POTENTIAL TAX LEGISLATION

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December 2, 2011

I. The Tax Relief Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "**2010 Tax Relief Act**").

a. The 2010 Tax Relief Act: The 2010 Tax Relief Act deferred the "sunset rule" of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("**EGTRRA**"), which reformed the estate, gift, and generation-skipping transfer ("**GST**") taxes, increased exemptions, repealed the estate and GST taxes in 2010, and restored these taxes in 2011.

i. The 2010 Tax Relief Act provides for changes in the estate, gift, and GST tax regimes in 2010, 2011, and 2012, and subsequently restores the 2001 law in 2013.

ii. How does the 2010 Tax Relief Act affect the practitioner?

1. Planners should evaluate all estate plans in light of new tax rules and decide how to change existing estate plans (if at all) to address potential opportunities offered by the new rules.
2. If the 2010 Tax Relief Act is not extended or is not made permanent, practitioners will only have a two-year (now one-year) opportunity to take advantage of some these changes.

b. Background on Transfer Tax Changes in EGTRRA: The 2010 Tax Relief Act generally provides for various tax provisions that apply for just two years. An understanding of the related EGTRRA provisions is necessary to fully understand these provisions.

i. EGTRRA substantially increased the $675,000 estate tax exemption in stages after 2001; for individuals dying in 2006 through 2008, the exemption was $2 million. It rose to $3.5 million for individuals dying in 2009.

ii. EGTRRA also changed the unified system so that the gift tax exemption amount remained at $1 million for all years after 2001.

1. Under the "sunset rule," the exemption was to be $1 million for both estate and gift tax purposes in 2011.

iii. Under EGTRRA, the top estate and gift tax rate was also reduced in stages. It was 45% for transfers occurring between 2007 and 2009. In 2010, there was to be no estate tax; however, the gift tax would remain with a top rate of 35%.

1. Under the sunset rule, the top estate and gift tax rate was to revert to 55% in 2011.

iv. For 2010, the basis rules for inherited property were designed similarly to the gift tax basis transfer rules; however, heirs had opportunities to get increases in basis.

1. For example, these so-called modified carryover basis rules would have permitted the basis of assets received from an individual dying in 2010 to be increased by $1.3 million and by an additional $3 million for assets going to a spouse.
2. Under the sunset rule, the pre-EGTRRA step-up in basis rules was scheduled to return for 2011.

v. EGTRRA provided for other changes to the transfer tax rules which were scheduled to disappear under the sunset rule. For example, it repealed the State death tax credit and replaced it with a deduction. The deduction was also scheduled to end and the credit was to return in 2011.

c. Summary of 2010 Tax Relief Act Estate, Gift, and GST Tax Provisions.

i. Increased Exemption and Reduced Maximum Rate. The 2010 Tax Relief Act lowers estate and GST taxes for 2011 and 2012 by *increasing* the exemption amount (the applicable exclusion amount) from $1 million to $5 million (indexed for inflation after 2011) and *reducing* the highest tax rate from 55% to 35%.[1] See Exhibit "C-1" for a Chart of Current Estate/GST Tax Law.

1. The $5 million exemption is applied on a per person basis; thus, married couples are provided a $10 million exemption. Additionally, the 2010 Tax Relief Act provides for a new portability feature for married couples (discussed below).

ii. Carryover Basis. The 2010 Tax Relief Act generally repeals the EGTRRA modified carryover basis rules that would have applied for purposes of determining basis in property acquired from a decedent who dies in 2010. Generally, a recipient of property acquired from a decedent who dies after Dec. 31, 2009 will receive stepped up basis (to fair market value) under the rules applicable to assets acquired from decedents who died in 2009.[2] However, an executor of an estate of a decedent who died in 2010 could have chosen to have the modified carryover basis rules of Internal Revenue Code (the "**IRC**") §1022 apply "with respect to property acquired or passing from a decedent" within the meaning of IRC §1014(b) instead of the estate tax.

iii. Portability of Unused Exemption between Spouses. Under the 2010 Tax Relief Act, any exemption that remains unused as of the death of a spouse who dies after December 31, 2010 is generally available for use by the

[1] IRC §2010(c), as amended by the 2010 Tax Relief Act §302(a).

[2] 2010 Tax Relief Act §301(c).

surviving spouse, as an addition to the surviving spouse's exemption. A surviving spouse may use the deceased spouse's unused exclusion amount (the "**DSUEA**") in addition to his or her own $5 million exclusion for taxable transfers made during life or at death.[3]

iv. The 2010 Tax Relief Act accomplishes the portability concept for decedents dying and gifts made after 2010 by defining the applicable exclusion amount as (A) the basic exclusion amount ($5 million for 2011, as indexed for inflation) plus (B) the DSUEA.[4]

1. DSUEA. For a surviving spouse, the DSUEA is the lesser of (A) the basic exclusion amount; or (B) the basic exclusion amount of the surviving spouse's last deceased spouse *over* the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts.[5]
    a. For the DSUEA determination, the unused exclusion is limited to the lesser of: (A) the basic exclusion amount; or (B) the last deceased spouse's remaining unused exemption amount.
        i. If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last such deceased spouse.[6]
    b. Important to note, notwithstanding the statute of limitations for assessing estate or gift tax, the Internal Revenue Service (the "**IRS**") may examine the return of a predeceased spouse at any time for purposes of determining the DSUEA available for use by the surviving spouse.[7]
2. The DSUEA is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise must file an estate tax return.
3. Notice 2011-82.
    a. This notice alerts executors of estates of decedents dying after December 21, 2010 that a Form 706 is required for an

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3 IRC §2010(c)(2), as amended by the 2010 Tax Relief Act §303(a).

4 Id.

5 *See* § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section § 2001(b)(1)".

6 IRC §2010(c)(4).

7 IRC §2010(c)(5)(B), as amended by the 2010 Tax Relief Act §303(a).

executor to elect under IRC §2010(c)(5)(A) ("portability election"), even if the executor is not otherwise obligated to file a Form 706.

4. Malpractice Risks:
    a. Not cautioning clients about the limitations of portability, such as not being applicable to state estate tax, GST tax, and post death appreciation of assets.
    b. Not filing the Form 706 to preserve portability.
    c. Not addressing the possibility of executor vindictiveness, such as a stepchild purposely not electing portability.
    d. Not assuring portability non-election; remember, if a Form 706 is filed and the preparer inadvertently forgets to choose for portability not to apply, portability will apply in default.
    e. Not maintaining adequate records.
    f. DSUEA and the effect on gift tax returns.
    g. Not obtaining appropriate disclosures in prenuptial agreements.
    h. Not receiving consent of the personal representative not to elect portability.
5. *Not so fast my friend*- Advantages of Credit Shelter Trusts.
    a. The use of a credit shelter trust still offers planning advantages:
        i. Protection of assets from creditors;
        ii. Ensuring assets remain in family bloodline;
        iii. Sheltering future appreciation from estate tax; and
        iv. Protecting against sunset of the 2010 Tax Relief Act.

v. Gift Tax Changes. Under the 2010 Tax Relief Act, for gifts made after December 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of $5 million (indexed for inflation) and a top estate and gift tax rate of 35%.[8] See Exhibit "C-2" for a Chart of the Current Gift Tax.

1. The 2010 Tax Relief Act also makes clarifying changes for computing estate and gift taxes. For purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under IRC §2001(c) at the time of the decedent's death are used to compute both (1) the gift

[8] IRC §2505(a), as amended by 2010 Tax Relief Act §302(b).

tax imposed with respect to such gifts, and (2) the unified credit allowed against such gifts.[9]

2. If a client makes a $5 million gift in 2011 and dies 25 years from now, the value of the gift will be:
    a. Over $54 million, assuming 10% growth; over $34 Million, assuming 8% growth; over $21 million, assuming 5% growth; and over $13 million, assuming 4% growth.

vi. GST Tax Changes. Under the 2010 Tax Relief Act, the GST exemption for decedents dying or gifts made after December 31, 2009 and before January 1, 2011 equals the applicable exclusion amount for estate tax purposes ($5 million).[10]

1. For decedents dying or gifts made after December 31, 2010, the GST exemption is equal to the basic exclusion amount for estate tax purposes ($5 million, indexed for inflation).[11]
2. The GST tax applicable rate for transfers made in 2011 and 2012 is 35%.[12]
3. The Act extends the EGTRRA modifications and the sunset rule until December 31, 2012; thus, all of the uncertainties surrounding the EGTRRA sunset provisions will be put off for another year or so.

d. Rev. Proc. 2011-52.

i. 2012 Applicable Exclusion Amount is $5,120,000 ($120,000 increase for inflation).

II. Why Today's Planners Have to Think Differently from an Estate Planning Perspective.

a. Impact of Future Legislation: A client's first question is how do you think future legislation will impact the estate and gift tax $5 million exemption amount?

i. Common Questions:

1. Will the transfer taxes be repealed?
2. Will all of the provisions "sunset" and will we return to the provisions of the 2001 Tax Act?
3. Will the current provisions become "2-year extenders" and be up for debate every 2 years?
4. Will a permanent, unified transfer tax system finally be enacted?
5. What will the exemptions be? Indexed or not?

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[9] IRC §2505(a), as amended by 2010 Tax Relief Act §302(d)(2).

[10] Although the GST tax is applicable in 2010, the GST tax rate as determined under IRC §2641(a), for transfers made during 2010 is 0%.

[11] IRC §2631(c).

[12] IRC §2641(a).

6. What will the transfer tax rate be?
7. Will there be "clawback" of previously "unpaid" transfer taxes?
    a. **Important to *note:*** Noting in the current law or legislative history suggests that the Treasury intended to implement/adopt a clawback approach.

ii. Believe it or not, what Congress passes and the President signs can actually happen with Obama as it did with Bush. Exemptions could go back to $1M and 55% in 2013. Don't be surprised, because anything can happen like it did at end of 2010. Why? The Congress and President do not appear capable right now to agree on anything. After repeal of the estate tax, who anticipated that estates would be able to elect out of an estate tax? Congress passed legislation in December 2010 enacting an estate tax which could be elected out of in order to avoid a constitutional challenge to its right to a retroactive application of estate taxes.

iii. You need to tell your clients this is the "Golden Age of Estate Planning." If the tax law returns to a $1M exemption with a 55% estate tax rate and/or discounts become unavailable (in order to pay off the $14 trillion of federal debt), your clients will give you a call in 2013 and ask you why you didn't notify them of available opportunities. The key point being is these opportunities won't remain forever!

iv. The Super Committee will likely not have a chance to deal with revisions to the estate tax law. Why? Congress intended to take a year off from transfer tax legislation after enacting two-year estate tax legislation at the end of 2010. Changes may occur during the 2012 lame duck session of Congress or in 2013.

1. Politics and Taxes.
    a. Deeply divided Electorate
        i. Gap in spending vs. income.
        ii. 70% to 80% are unhappy with the current situation.
        iii. Electorate has to do something now.
    b. The current situation is extremely grim and public rhetoric is sky rocketing (see the Tea Party and Occupy Movements).
    c. Where are we going on Estate and Gift Taxes?
        i. Obama administration: Wants high taxes and then cuts deal at the end of 2010, which is a wholesale capitulation to Republicans.
        ii. Good chance the estate tax issue is not resolved in 2012.
    d. Three Ways to Change Taxes:

i. A Code Overhaul with deficit reduction;
ii. 2012 initiative after election; or
iii. Incremental approach.

v. The bottom line is people in Washington who are in the know, don't know whether planning techniques available today will be available tomorrow.

vi. Clients need your help in determining what they want and will ask why you didn't tell them to take advantage of the Golden Age of Estate Planning.

vii. 9-9-9 Plan.

1. Consider the possibility of a flat tax or a valued added tax. How about a 9% flat income tax, value added tax and estate tax?
2. While the plan would simplify or remove the various tax regimes and spread the tax burden, many point to Europe's implementation of the VAT as the cause for their anemic economies.

b. Discuss Estate Tax Strategies to Utilize $5M Exemption. Remember, estate planning is a journey and not a destination.

c. Client Responses to your Recommending Utilization of Estate Planning Strategies and Techniques to take Advantage of Low Interest Rates, Available Discounts and Depressed Values of Assets:

i. Let's take advantage of opportunity now.

ii. Wait until second half of 2012.

iii. Want to utilize exemption, but worried about beneficiaries not understanding the donor's values, having too much or not being able to manage money in a fiscally responsible manner.

iv. Want to retain control and/or access, but want to be able to utilize $5M exemption.

v. Yes, but clients may have special non-tax concerns.

d. Want To Utilize Exemption.

i. Use $5M exemption to take advantage of fractional interest discount opportunities, low interest rates and depressed values of assets.

ii. If no current discount opportunities are available, then consider using a portion of $5M exemption to leverage life insurance inside an ILIT and avoid complexity. Always follow the KISS Theory.

e. Worried About Beneficiaries.

i. Use GST Dynasty Trusts with asset protection features as a result of grantors' increased emphasis on asset protection for beneficiaries.

ii. Narrow distribution standards with an independent trustee making distributions.

iii. Motivating behavior through Incentive Trusts does not work accordingly to studies over the past 40 years.

iv. Consider a Financial Skills Trust to improve business and entrepreneurial skills of beneficiaries in order for them to learn to be financially and managerially responsible. This type of trust use autonomy concepts from the business world to teach beneficiaries under a results oriented trust environment to focus on results rather than on dictating the pathway a beneficiary should follow to get there.

1. Google: Google has an internal policy that permitted employees to work on their designated projects four days a week and work on personal projects on the remaining day. Over 50% of Google's new ideas have been generated from the one day a week employee personal project day.

v. Will respond to an intrinsic method which breeds creativity and responsibility.

vi. Businessmen love the idea of using a Financial Skills Trust to prepare the next generation to handle management responsibility and to avoid family business battles. These skills would include living within your means, not abusing credit, management of investments, accounting for assets, procuring a job for what you need, and involvement in charities.

vii. Trustees can focus on the need for education and training before large distributions are made.

viii. See Paragraph VI.c pertaining to the transfer of assets to Non-Reciprocal Spousal Trusts to Utilize Portion of $5M exemption.

f. Special Non-Tax Concerns.

i. Asset Protection for Lineal Descendants from Predators, Creditors, Ex-Spouses, Government and Themselves. Clients Need to Understand That Not Being Asset Protected Means They Don't Have What They Think They Have.

1. Dynasty Trusts vs. Vesting Trusts. (Very Important Topic).
2. Self-Settled Trusts vs. Foreign Trusts. No Self-Settled Trust Legislation in Florida.
3. Prenuptial Agreements vs. Stealth Prenuptial Agreements.
   a. Can a prenuptial agreement be required to inherit?
   b. Is deferral of vesting the answer?
4. Family Limited Partnerships - Charging Order as the Sole Remedy.

ii. Distribution Standards.

1. HEMS – Limited Access with Ascertainable Standard.
2. Best Interests – Broad Access with Asset Protection.
3. Discretionary – Uncertain Access with Asset Protection.
4. Incentive Trusts – Grantor seeks to encourage certain Behaviors and Approaches.

5. Financial Skills Trust Approach – Grantor seeks to focus on Beneficiaries Obtaining Financial Skills.
    a. New approach.
    b. Result Oriented.
    c. Mission Statement.
6. Grantor's Philosophy: Tailor the Standard to Meet Grantor's Expectations.
    a. Give beneficiary enough to do something, but not enough to do nothing.
    b. Build philosophy into the document as to when and how distributions should be made.
    c. Sudden money can be a nightmare. Lottery winners often go bankrupt.

iii. Selection and Removal of Trustees.

1. Family Members - Responsibility, Time Commitment and Personal Liability.
2. Independent Trustees.
    a. Why? Asset Protection!
    b. When Should They Become Involved in the Process?
    c. Who Should Have the Right to Remove and Replace, and How Often?
    d. Are They Worth It?
3. Co-Trustees.
    a. Who Should They Be?
    b. Should Roles and Responsibilities Be Separate?
4. Roles of Trustees.
    a. Administrative Trustee - Do You Want Them to Monitor Investments? Remember, the most important thing is return of investment and not return on investment.
    b. Investment Trustee or Committee.
    c. Distribution Trustee.
    d. Trust Protector - Your Ace in the Hole.
5. Directed Trusts vs. Delegation of Trustee Responsibilities.
    a. The Florida Trust Code authorizes directed trusts and delegation of trustee responsibilities.
    b. Directed Trusts. The terms of the trust must expressly authorize a person with the power to direct certain actions of the trustee. The trustee will generally not be liable for the acts of the power holder, unless the attempted exercise violates the terms of the trust agreement or the fiduciary

duty owed to the beneficiaries. The power holder is subject to the same fiduciary standards as the trustee.

c. Trustee Delegation of Authority. A trustee may delegate any duty and/or power provided that the delegation would be proper for a trustee of comparable skill under the circumstances. A trustee will not be liable for acts of the agent, if the trustee exercised "reasonable care, skill, and caution" when selecting the agent, defining the scope of the delegation and monitoring the agent's actions. The agent is subject to the jurisdiction of the Florida courts and owes a duty to exercise reasonable care. Unlike the directed trustee, a delegated trustee has selection and monitoring duties and the agent is held to a lesser standard of care, i.e., reasonable care standard rather than a fiduciary standard.

6. Reformation/Modification and Decanting of Trusts.
7. Letter of Wishes. When and Why? Provides an Opportunity to Understand What Clients Are Really Thinking and Want to Happen. Perhaps a Charitable Mission Statement Might be Included in a Letter of Wishes or in a Video.
8. Economic Risk Spreading.
    a. Off-shore Investments.
    b. Hedge Funds.

III. Planning for Family Business Interests With a $5 Million Applicable Exclusion Amount.

a. Potential Benefits of Lifetime Gifts.

i. Political Risks of not using the Exemption.
    1. Consider what's happened over the past couple of years… anything is possible! It's possible that the applicable exclusion amount will revert to $1 million or be reduced to $3.5 Million after 2012.
    2. If one spouse dies in 2011 or 2012, there is uncertainty as to whether the DSUEA will cease to be useable after 2012.
    3. Possible changes to the GST exemption amount after 2012.

ii. Transfer future income and appreciation from donor's estate tax base.

iii. Ancillary wealth-transfer benefits from valuation discounts:
    1. IRC §2036(a) is inapplicable in a federal gift-tax examination; and
    2. Potential risk of future regulations under IRC §2704(b) to restrict valuation discounts for transfers of family controlled entity interests.

iv. Maximize the $5 million GST exemption benefit:
    1. $10 million for married couples that split lifetime gifts.
v. Use grantor-trust structure to permit growth during donor's remaining lifetime without reduction by income taxes.
    1. Consider the leverage benefits of creating a $5 million or $10 million base in grantor trust(s), to support future installment-sale transactions.
    2. JP Morgan study indicated that the tax benefit of the grantor paying the trust's income taxes may be up to a 30% discount. The point being that clients do not need to push the discount valuation envelope in valuation reports.

b. Potential Risks of Using Exemption for Lifetime Gifts.

i. Transferred assets may go down or lose value; however, may still receive a benefit if the applicable exclusion amount is later reduced.
ii. No basis step-up at donor's death.
iii. Donor may not be in the financial position to make a $5 million or $10 million gift.
iv. Potential for a clawback tax at the donor's death if the applicable exclusion amount is reduced without a legislative fix:
    1. Could impair marital deduction or charitable deduction; or
    2. Possible distortion to the donor's overall disposition plan.
v. Potential for "sunset" after 2012 to leave a generation-skipping trust subject to a partial generation-skipping transfer tax.

c. Opportunity to Clean-up or Simplification.

i. Forgiveness (or repayment) of intra-family loans.
    1. Gift-and-loan repayment provides clean reporting on federal gift-tax return.
ii. Cancellation, reduction or repayment of promissory notes from previous installment sale transactions.
iii. Potential to fund ILIT's.
    1. Salvage or replace existing under-performing life insurance policies.
    2. Initiate or pre-pay life insurance coverage without the complexities of using Crummey withdrawal rights.
    3. Roll out a split-dollar arrangement.
    4. Pay off or pay down a premium loan arrangement.
    5. Planning pointers:
        a. May be advisable for individuals with existing ILITs to purchase additional life insurance or keep policies that they were thinking about terminating.

b. Consideration should be given to making a large gift to an ILIT to protect against the exemption amount being decreased in the future rather than making transfers to the ILIT as premiums come due.
c. Insurance should be an essential consideration in constructing estate plans because of the uncertainty of the estate tax system going forward and to ensure liquidity to pay possible estate tax.

iv. Opportunity to transfer a risky interest in a family entity.
1. General Partner interest.
2. Limited Partner interest or membership interest in an entity that has been defectively managed.
3. Preferred ownership interests or non-pro-rata ownership interests that may have IRC §2701 issues.

IV. Estate Freeze Techniques.

a. GRATs.

i. An individual (the "**Grantor**") transfers assets to a grantor trust and retains an annuity from the trust for a term of years.
1. To avoid a gift upon formation, the retained annuity is designed to equal the value of the assets transferred ("***zeroed out***") based upon the term of the trust and an assumed rate of growth over the term set forth the by the treasury department (*i.e.*, the 7520 rate).
2. Structuring a significant gift element in a GRAT results in a greater probability of wasting some or all of the exemption if a shorter time horizon or more volatile asset is used.
3. The 7520 rate is a "hurdle" which is necessary for the trust assets to overcome in order for the GRAT to be successful.
4. If the total return of the trust outperforms the 7520 rate (1.4% in November), the excess value passes to the beneficiaries of the GRAT free of estate and gift tax.
5. In addition, the Grantor is responsible for all of the income taxes generated by the assets of the trust – An additional indirect gift.

ii. Longer vs. Shorter Term Single GRATs: Large Cap vs. Small Stock.
1. For maximum remainder scenarios for both large-cap stocks (i.e.- S&P 500 index) and small-cap stocks, a GRAT term of six to seven years appears to produce the optimal financial result.
a. The remainder passing to family is approximately 125% of the amount originally transferred to the GRAT for large-cap stocks, and about 250% for small-cap stocks in GRATs

with a six to seven year term.

iii. Rolling GRATs.

1. In comparing a single nine-year GRAT with a series of two-year rolling GRATs, the rolling GRATS reflect a substantially higher wealth shift.
2. JP Morgan has recently done an analysis with the following assumptions: 3% or 6% IRC §7520 rate throughout the term, $10 million initial funding amount of a single U.S. large cap stock.
    a. The JP Morgan simulation analysis indicated that rolling GRATs have a considerable advantage ($8.65 vs. $2.39 million at 3% rate and $7.26 million vs. $170,000 at 6% rate).

b. Sales to an Intentionally Defective Grantor Trust ("IDGT").

i. Steps:

1. Create or utilize an existing family entity and trust.
2. A new trust should be funded with a gift equal to 10% of purchase price and/or obtain beneficiary guarantees. Consideration should be given to allocating GST exemption to the gift.
3. Parent sells the entity interest to the trust at a discounted rate.
    a. The sale does not generate capital gains because sold to a grantor trust; and
    b. The trust pays for the entity interest with a note, typically an interest only/balloon note at the current AFR.

ii. Income Tax:

1. No gain on sale to the grantor if note paid before death.
2. Grantor pays income taxes on trust income: Parent can remain taxable on all income, thereby making an indirect gift to the beneficiaries of the trust.

iii. Low interest rate environment and depressed values for assets create the perfect storm.

iv. Shifts appreciation beyond the interest rate (AFR) to the beneficiaries.

v. Negatives:

1. No specific Code Section or regulation.
2. The asset value may decline below the note, "wasting" the gift.
3. There is no clear way to have valuation "formula clause."

vi. Possible disadvantages compared to a financed net gift:

1. Seeding required,
2. Potential 2036 inclusion,
3. Cash flow to make interest payment,
4. Leveraged investment risk if decrease in value of assets sold, and

5. Large note is still in Grantor's estate.

vii. Potential solutions to "Underwater" transactions:
   1. Renegotiate to a lower interest rate or extend the term.
   2. Reduce the principal amount of the note.
   3. Contribute the underwater note to a GRAT (using the reduced value of the note as the value of the contribution to the new GRAT).
   4. Future appreciation goes to the GRAT remainder beneficiaries.
   5. Grantor can sell the note to a new grantor trust.

viii. Consider Using a GRAT as a Transferee/Beneficiary of a Defined Value Clause Gift.

c. Financed Net Gifts.

i. Steps:
   1. Donor makes a net gift.
   2. Donor lends to the donee the funds to pay the gift tax.
   3. Loan bears interest at the relevant AFR.

ii. The transaction is similar to a Sale to Defective Trust, but:
   1. Simpler,
   2. Decreased leverage – less risky,
   3. Principal balance on the note is much less (only the amount of the gift tax),
   4. Less cash flow required,
   5. Probably less exposure to estate tax inclusion (under 2702 and 2036),
   6. Shrinks estate value,
   7. Valuation risk on audit is reduced, and
   8. Tax exclusive gift tax rate (if donor lives three years after making the gift).

iii. Disadvantages:
   1. Payment of gift tax
   2. Possible income tax (donor will recognize capital gain to the extent of gift tax liability exceeds the donor's adjusted basis in the property transferred) unless made to a grantor trust, and
   3. Three year rule.

d. Family Limited Partnerships.

i. Type of Client:
   1. Those who can afford to sell the partnership units to a grantor trust (or give them away) because in the long term, a donor's paying income taxes on a grantor trust and estate freezes are more powerful tools than discount planning.

2. Those who have a compelling investment reason for the creation of the partnership (*e.g.*, modern portfolio theory, ensure active professional management of the assets, lower the unit cost of managing the assets by pooling the assets, ensure a buy hold strategy, *etc*).
3. Those who have family investment goals that include the benefits of bifurcating the partnership into preferred and growth interests.
4. Those who have other non-tax reasons that are not investment reasons (*e.g.*, protection of "family" management, creditor and divorce protection, *etc*). Please note these reasons alone may not be sufficient to avoid an IRS 2036 attack.

ii. Audits.
1. IRS is accepting double discounts.
2. 30% discounts are being approved on audit.

iii. Bad facts will get you in trouble.

V. Planning Opportunities in Low Interest Rate Environments.

a. Applicable Federal Rates ("AFRs"). See Exhibit "E-2" for a Chart of AFRs.

i. The AFRs (assuming annual compounding) for November 2011 are:
1. Short-term: (<3 years): 0.19%
2. Mid-term: (3-9 years): 1.20%
3. Long-term (>9 years): 2.67%

ii. AFRs are adjusted monthly by the IRS.

b. 7520 Rate.

i. The November 2011 7520 Rate is 1.4%.

ii. Section 7520 provides that if an income, estate, or gift tax charitable contribution is allowable for any part of property transferred, the taxpayer may use the 7520 interest rate for the month of the transfer or may elect to use the rate for either of the 2 months preceding the month of transfer.

c. Private Financing.

i. Intra-Family Loans.
1. Intra-family loans are a simple planning technique to effectively shift wealth between family members.
2. Intra-family loans are great for families who take advantage of annual exclusion gifts every year and want to transfer additional tax free wealth to family members.
3. The premise is that the funds loaned will appreciate at a greater rate than the interest rate required to be charged on the loan, known as the "AFR."
4. Example:
a. Assume: a 2 year loan of $1,000,000 to a trust for children and money grows at 7% annually.

b. Result: The trust will earn $70,000 annually, but only owe interest of $6,100. The transfer-tax free growth is $63,900.

5. Planning opportunity: This may also be the perfect opportunity to consider refinancing intra-family loans that may have been made in the past at significantly higher interest rates.
    a. Any such negotiation should be at arm's length; and
    b. If the interest rate is reduced, taxpayers should consider having the borrower provide some additionally consideration, such as a prepayment of a portion of the principal or a reduction of loan duration, in exchange for the reduction of interest rates to current AFR's.

ii. Loans to an Irrevocable Life Insurance Trust utilize leverage to create wealth transfer opportunities. See Exhibit "E-1" titled Historically Low Interest Rates: Planning Opportunity! and "F-1" and "F-2," Hypothetical Summary of Private Financing Transaction.

d. GRATs.

i. Perfect Low Interest Vehicle, because the retained annuity is being valued with a low interest rate, it is undervalued as an economic matter if the assets are expected to grow greater than the 7520 rate (1.4% in November).

ii. The lower the interest rate, the smaller the annuity the Grantor has to retain to produce a zero gift because the annuity the Grantor has retained is worth more.

e. Sale to an IDGT.

i. Shifts appreciation in assets sold to the IDGT beyond the interest rate (AFR) to the beneficiaries of the IDGT free of estate and gift tax.

ii. The lower the interest rate (AFR), the smaller the hurdle to overcome in order to pass value to the beneficiaries.

f. Private Annuities.

i. Note payments on a sale to a defective grantor trust or low interest loan to family members will be lower when interest rates are low and the payments on a private annuity will also drop as interest rates fall.

ii. At a 1.4% 7520 rate, the amount of the annual annuity is extremely favorable.

iii. It is important to note, however, that the proposed regulations provide that the purchase of a private annuity with appreciated property results in immediate recognition of gain; thus, the gain cannot be spread out over the annuitant's life expectancy.

g. Charitable Lead Annuity Trusts.

i. Highly favored in Low Interest Times.

ii. Can be zeroed out.
iii. Annuity payment to charitable beneficiary(ies) and remainder to non-charitable beneficiary(ies).
iv. No requirement for a term of years. May use a measuring life.
v. Any growth in the trust in excess of the 7520 rate passes transfer tax free to the non-charitable beneficiary at termination of the CLAT.
vi. Only for the charitably inclined wealthy client.
vii. CLT ordering rules: Income must come out pro-rata, cannot distribute all ordinary income out first (worst in/first out – won't work)!

h. Charitable Gift of a Remainder Interest in a Personal Residence or Farm.

i. Larger Charitable Deduction in low interest rate environments.
ii. Grantor's retained use of the residence is equal to an income stream; therefore, the lower the interest rate, the less the retained residential interest is worth. As a result, the charitable gift is worth more.
iii. Grantor is deemed to be keeping less and giving more.

i. Unitrusts - virtually unaffected by interest rates.

j. Charitable Gift Annuity Alternative: Charitable giving is 49% down due to donors' psychological fear of parting with assets; which, in turn, has accentuated the cash needs of Charities. See Exhibits "G-1" through "G-5," Charitable Gift Annuity Alternative.

i. Key is this is a win-win gifting design. This alternative is not a financial planning design involving a gift today or a bequest at death; however, charitable intent is necessary.
ii. Assume donor has an investment of $100K generating a 4% return.
iii. Charity receives an upfront cash donation from the donor equal to the present value of the amount the charity would otherwise receive at the back end of a charitable gift annuity.
iv. The remaining proceeds are invested in a single premium annuity, and the annuity proceeds are utilized to provide the donor with annual income of $4,000 under a Guaranteed Income Contract and to pay an insurance premium for life insurance policy providing a guaranteed death benefit to the donor equal to his $100K investment.
v. Ultimate Results:
    1. Donor receives the same 4% income from Guaranteed Income Contract, a 100% return of his or her contribution, and an immediate charitable deduction.
    2. The Charity receives a cash gift up front and is relieved of the administrative and financial obligations and responsibilities of a charitable gift annuity.

3. Alternatively, the gifting design can replace the payment of insurance premiums for a guaranteed death benefit with an annual gift to charity. Alternatively, the donor could use the annual income from the Guaranteed Income Contract to make an annual charitable gift.
4. The bottom line is a win-win planned giving alternative with options for a donor to give a cash gift at inception and annual gift during their lifetime, his and receive an annual payment of income and a guaranteed death benefit equal to his or her investment.

k. Virtual Endowment With a Twist.

i. Alternative to an endowment bequest at death to a Charity through an approximately 4% discretionary or restricted gift annually.
ii. Charity would treat the transfer as if already been made. Donor would contribute 4% of his virtual endowment each year to provide the Charity with current funds. Thus, the Charity is able to distribute the same amount annually toward the purpose of the endowment that would have been otherwise available if the entire endowment had been funded from inception.
iii. Donor makes provision in his will to create endowment with no binding legal obligation.
iv. Donor is recognized currently by Charity. Statistically, 90% to 95% of pledged endowments are funded.
v. Donor becomes vested in endowment as a result of annual contributions and becomes a participant in the Charity's annual planned giving campaign.
vi. Works well for high income clients who do not have currently available capital to create the endowment, but want to further the purpose of the endowment annually.

l. Vehicles That Are Not Favored in Low Interest Rate Environments.

i. Charitable Remainder Trusts
    1. Only useful in a low interest rate environment if non-itemizing taxpayer who cares more about amount of taxable income than about a charitable deduction; otherwise, CGAs and charitable remainder trusts (CRTs) are not attractive in low interest rate environment.
    2. Consider transferring artwork into a CRT due to the 28% tax rates applicable to sales of artwork.
ii. Qualified Personal Residence Trusts

1. Retaining use of a residence is equivalent to retaining income stream; and in the case of a QPRT, the grantor value of the retained usage is less than the remainder value.
2. QPRTs provide the most advantageous outcomes when interest rates are high. For example, if a taxpayer creates a 10 year QPRT with a $1 million residence when the section 7520 rate is 8%, the gift to the taxpayer's children is $314,710. At November's 1.4% rate, that same gift is now increased to $591,260. But unlike a GRAT, a residence does not have to appreciate to make a QPRT successful. If at the end of 10 years, the taxpayer's house has not appreciated a dime and is still only worth $1 million, the taxpayer is still ahead because I have gotten $1 million asset to my children for a gift tax transfer value of $591,260. So go ahead with your QPRTs, but be aware that they would have worked better at a higher interest rate.

VI. Asset Protection.

a. New Florida Statute 736.0505(3).

i. Clarifies that assets passing in trust for the settlor of an "Inter Vivos QTIP Trust" after the death of the settlor's spouse are not considered to be held in a self settled trust unless the initial transfer was a fraudulent conveyance.
ii. Effective July 1, 2010
iii. Similar to provisions in Arizona, Michigan and Delaware
iv. Enhance Planning Opportunities for asset protection for the benefit of the settlor of an Inter Vivos QTIP Trust.

b. Inter Vivos Irrevocable QTIP Trusts.

i. Both an asset protection and estate planning vehicle
ii. A way to effectively utilize both spouses' exemptions
iii. Generally shields assets from both spouse's creditors
iv. Upon settlor's spouse's death:
    1. the assets in the trust will be includible in settlor's spouse's gross estate under IRC 2044(b)(1)(B) (by virtue of the required election under IRC 2523(f));
    2. the assets may continue to be held in trust for the benefit of settlor; and
    3. the creditors of the settlor will not be able to reach the assets.
v. Upon the settlor's subsequent death, the assets will not be includible in settlor's estate (and thus will not be subject to estate taxes).
vi. This is a vehicle that enables you to fund the spouse's estate tax exemption, without exposing trust assets to the spouse's creditors or settlor's creditors.
vii. Specific exception in QTIP regulations that Section 2036/2038 issues do not apply to gifts to an Inter Vivos QTIP where assets are left in a bypass

trust for donor spouse. Treas. Reg. 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11.

c. Grantor Can Retain Control and Access, and Utilize a Portion of $5M Gift Tax Exemption Through the Transfer of Assets to Non-Reciprocal Spousal Trusts. See Exhibit "D" for a Chart of an Intervivos Spousal Trust.

i. This is a strategy under which your clients can have their cake and eat it too. If your client is reluctant to make a gift at this time, but does not want to lose the opportunity to use the $5M exemption, each spouse can create a spousal trust for the benefit of the other spouse. The creation of a lifetime credit shelter trust permits the grantor to retain access and control as a result of his or her spouse being the primary beneficiary and children being secondary beneficiaries. If funds are needed, the spouse can receive a distribution from the trust. The spouse can even be a trustee with a HEMS standard.
   1. Key point is you do not have to gift solely to your children to use the $5M exemption.

ii. Flexibility in design.
   1. The trust document would not require distributions only to spouses or direct distributions of all net income to spouses.

iii. Funds could accumulate inside the trust and not be subject to any future transfer taxes. Moreover, if the trusts are grantor trusts, the income tax is removed from the grantor's estate tax-free.

iv. Risk of spouse's premature death can be reduced by procuring life insurance.

v. Risk of divorce mitigated by the creation of non-reciprocal spousal trusts. However, the IRS may argue the reciprocal trust doctrine requires the transferred funds to be brought back into the grantor's estate. Spousal trusts can be drafted to be non-reciprocal by using different trustees, lifetime beneficiaries, powers of appointment, distribution standards, and tax years.

vi. Be aware, however, of limitations on gift splitting because of right of spouse to distributions.

d. Inherited IRAs. In response to earlier cases in various states questioning the creditor protection aspects of an inherited IRA, Fla. Stat. §22.21(2)(c) was amended to expressly include IRAs in Florida's statutory protection scheme.

e. Domestic Asset Protection Trusts for Single Individuals.

i. A single person may create a domestic asset protection trust ("**DAPT**") in a state with DAPT legislation, and designate himself/herself as a contingent beneficiary.

ii. A DAPT can provide the grantor the ability to transfer assets out of their gross estate, while maintaining the ability to potentially receive the assets.

iii. There are no requirements for the trustee to make distributions, so growth can accumulate (appreciation free of estate, gift or GST tax) and, depending on the state, the DAPT can be protected from the grantor's creditors and creditors of any remainder beneficiaries.

f. Florida Single Member Limited Liability Companies: See Exhibits "A," "A-1" and "A-2."

VII. Hot Topics and Recent Developments.

a. Graegin Loans – A Less Attractive Option.

i. An estate tax advantage exists for an estate to borrow funds from related parties. The estate will be able to deduct the present value of the aggregate interest payments and thus save estate taxes.

ii. If the lender is a family member, the individual income tax rates for the family member are lower than the estate tax rates or if the lender is a family foundation the income taxes for the foundation are almost entirely eliminated.

iii. A Graegin loan from a FLP runs the risk of the estate not being able to take an interest deduction and risking an IRC §2036 issue.

iv. Treas. Reg. §20.2053-3(a) requires that estate tax deductions be actually and necessarily incurred in order to be deducted.

v. The tax court looks to see if the borrowing is "necessary":

1. *Murphy* and *Keller*:
    a. In both cases the court allowed the interest deduction for amounts borrowed from a FLP (both 9 year notes).
    b. Both cases showed that the borrowing was "necessary" for the estate administration.
2. *Black:*
    a. The interest deduction for a Graegin loan from a FLP was denied.
    b. The Court held that the borrowing was not "necessary" for the estate administration, mostly because the FLP sold the stock and loaned the sale proceeds to the estate instead of just distributing them – the Court reasoned the loan process was a just a recycling of value.
3. *Stick:*
    a. The IRS disallowed the interest expense deduction for Graegin loan interest.
    b. The estate was not entitled to an interest deduction because: (1) it had sufficient liquid assets to pay its estate tax liabilities and other expenses without borrowing; and (2) it did not show that the loan was "necessary."

b. Sharkfin CLATs.

i. Fixed nominal annuity payments are made to charity(ies) each year followed by a substantial back-loaded balloon payment to charity(ies) at the termination of the trust.

ii. Allows for significant build up of funds within the CLAT in order to maximize amounts passing to non-charitable remainder beneficiaries (*e.g.*, family members).

iii. **Planning pointer**: can use the funds initially transferred to purchase a single premium life insurance policy on settlor's life.

1. At Settlor's death (end of CLAT term):

a. a portion of the life insurance proceeds are used to fund the back-loaded balloon payment to charity; and

b. the remaining life insurance proceeds, plus any other funds in the CLAT will pass to family members.

iv. IRS has not clarified its position on the validity of shark –fin CLATs.

v. Planners should exercise caution.

c. Passive Activity Loss Rules to Fiduciaries.

i. IRC 469, passive activity loss (PAL) rules:

1. Losses from a trade or business may not be currently deducted under the PAL rules if the taxpayer does not materially participate in the trade or business.

2. Material Participation is only present if the taxpayer is involved in the activity on a regular, continuous, and substantial basis.

ii. Under a Private Letter Ruling, the IRS takes the position that trusts materially participate in an activity under the PAL rules only when their trustee participates in the operation of the trade or business on a regular, continuous and substantial basis. PLR 201029014.

iii. The Regulations provide tests on how individual taxpayers can meet the test, but does not provide examples for trusts and estate.

iv. This PLR provides that the only way for a trust to establish material participation is if the fiduciary (trustee) is involved in the operations of the activity on a regular, continuous and substantial basis. Can only look to the activities of the trustee (not the beneficiaries).

d. Disclaimer Planning and Portability.

i. Disclaimer planning (in a harmonious family) avoids a great deal of uncertainty about how future legislation may distort an estate plan. In a disclaimer plan, all assets pass to the spouse but if the spouse disclaims, the disclaimed assets pass to a disclaimer trust. A surviving spouse in a disclaimer plan, however, loses the ability to have a power of appointment over the disclaimer trust. One option is for the disclaimer trust to provide for an independent trustee, who may be appointed by the surviving spouse, to decant to trusts that affect beneficial enjoyment in a way similar to one with a power of appointment.

ii. Another option to consider is funding a reverse QTIP trust with an amount equal to the decedent's GST tax exemption (which is not portable), and have an amount equal to the decedent's remaining estate tax exemption and possibly the surviving spouse's remaining exemption pass outright to the surviving spouse who would immediately use her gift tax exemption plus the DSUEA to fund a grantor trust for descendants.
    1. Unless there is a clawback, immediately using the DSUEA alleviates the concern about the repeal of portability or loss of DSUEA as a result of remarriage because the transfer has already occurred.
    2. Additional wealth can be transferred as a result of the grantor trust status by the surviving spouse paying the income tax on income accruing to the trust.
    3. Because there is no "ordering rule" for use of DSUEA and the surviving spouse's own exemption, this strategy works best if the surviving spouse's gift uses all of the available exemption so that ordering is irrelevant.

e. Domestic Asset Protection Trusts.

i. 12 states have adopted self settled spendthrift trusts (the law is not the same in all states): Alaska, Colorado, Delaware, Missouri, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Nevada and Wyoming. Self-settled trust – where the grantor is a discretionary beneficiary.

ii. The client establishes a trust in one of the 12 states so that creditors cannot have access to the trust.

iii. Could settle the trust naming only the spouse as beneficiary so that settlor is not a direct beneficiary of the trust. (The settlor does not care if the money goes to him or his wife, if they are happily married.)

iv. Lessen 2036 concern by giving someone the power to remove settlor as beneficiary – can be exercised when settlor is near death.

v. **PLR 200944002** – Completed Gift (Alaska law) – because settlor cannot re-vest beneficial title or change the beneficiaries.

f. Decanting.

i. Enabled by state law (10 states now) or case law;

ii. States with statutes include: Alaska, Arizona, Delaware, Florida, New Hampshire, New York (first state to adopt), North Carolina, South Dakota and Tennessee.

iii. Common Law States: Florida (1940), New Jersey (1969) and Iowa (1975).

iv. Florida – first case: Phipps vs. Palm Beach Trust Co. (1940).

v. The rules are not the same is every state

vi. Florida requirements:

4. The trustee must have absolute discretion.
    a. Florida defines absolute discretion to include "best interests, welfare, comfort and happiness," but not health, education, maintenance or support."
    b. Unlike Delaware that allows the trustee to decant including discretion limited to health, education, maintenance and support.
5. A new beneficiary cannot be added to the second trust, but a beneficiary of the first trust may be excluded under the second trust.
6. Second trust must be for the current benefit of one or more of the beneficiaries of the first trust.
7. Vesting of the second trust cannot be postponed beyond RAP period of first trust.

vii. **Be careful not to trigger unnecessary taxes**:

1. Income Tax:
    a. Change of a beneficial interest.
    b. Change of grantor status.
    c. DNI unanswered questions (deemed distribution to beneficiary?).
    d. Partial or non-pro rata decanting could be a deemed a taxable exchange to beneficiary of first trust under *Cottage Savings* analysis.
2. Gift tax:
    a. Beneficiary's consent could trigger a gift tax if required to approve/consent to the decanting.
    b. If the beneficiary is also trustee could trigger gift tax.
3. Estate tax:
    a. Decanting grants beneficiary a general power of appointment.
    b. Beneficiary is the trustee.
    c. Settlor's involvement in decanting will result in inclusion under 2036 or 2038.
    d. Decanting resulting in an incomplete gift that becomes complete at death.
4. GST – Beware of Grandfathered trusts (pre-1985 trusts).
5. ACTEC has submitted a proposed revenue ruling in connection with decanting. The proposed revenue ruling focuses on the estate, gift, income and GST tax effects of the exercise by a trustee of

power granted under state law to transfer property held in one trust to another trust.

g. Estate of *Clyde W. Turner, Sr. v. Comm'r*, T.C. Memo 2011-209.

i. Mr. Turner (while in his 80's) and his wife established a FLP and transferred the majority of the couple's wealth into the FLP, mostly liquid assets, in exchange for the partnership interests. Additionally, Mr. Turner established an irrevocable life insurance trust and between 2000-2003 Mr. Turner paid the life insurance premiums directly, without first contributing the money to the trust to allow the trust to pay the premium. The trust agreement provided that the beneficiaries had "Crummey powers" after each direct or indirect transfer to the trust.

ii. Upon Mr. Turner's death, the IRS asserted that one-half of the net asset value of the FLP was includible in Mr. Turner's estate under IRC §§2035 (transfer 3 years prior to death), 2036, and 2038. The IRS also asserted that the premiums paid on the life insurance policies did not qualify for the gift tax annual exclusion and should be treated as adjusted taxable gifts for purposes of the estate tax calculation.

iii. One-half of the FLP's assets were included in Mr. Turner's gross estate under IRC §2036 because "the transfer was not a bona fide sale for adequate and full consideration. The rationale being that the transfer was not motivated by legitimate and significant nontax purpose, and [Mr. Turner] retained by both express and implied agreement the right to possess and enjoy the transferred property, as well as the right to designate which person and persons would enjoy the transferred property."

iv. The life insurance premiums paid directly by Mr. Turner qualified for the annual exclusion and were not deemed adjusted taxable gifts for purposes of the estate tax calculation. The Tax Court noted that the key factor in a present interest gift such as this is whether the beneficiary had the "legal right to demand" the withdrawal - not whether the beneficiary was likely to receive the present enjoyment of the property. The trust terms provided that the beneficiaries had the absolute right and power to demand withdrawals from the trust after each direct or indirect transferred to the trust.

v. Planning Pointer: The IRS will likely be aggressive in IRC §2036(a)(2) situations (focusing on the *in conjunction with* language) in light of the *Turner* case.

vi. Crummey Trust Drafting Implications: Indirect gifts to the irrevocable life insurance trust by virtue of the decedent's payments of premium payments were subject to the Crummey withdrawal power because the trust

agreement clearly provided that the *withdrawal power applies to both directs and* ***indirect*** gifts to the trust.

1. Drafting the trust agreement in a manner that allowed for indirect gifts won the day in this case.

vii. Planning Pointer: The Tax Court rejected asset consolidation and centralized management as a significant nontax purpose. The following factors indicated that the transfers were not Bona Fide sales:

1. Decedent participated on both sides of the transaction;
2. Commingling of personal and partnership funds;
3. Delayed transfer of assets to the partnership after the partnership's formation; and
4. Retained possession of enjoyment under §2036(a)(1), such as:
    a. High management fee;
    b. Right to amend the partnership agreement;
    c. Transferring a majority of assets to the partnership;
    d. Purpose appears to be primarily testamentary; and
    e. Retained powers

viii. **Current Structuring of Family Partnerships in Light of Increased Court and IRS Sophistication- Use Common Sense, Follow the Rules and Be Within the Norm on Valuation Issues to Avoid IRS Audit.**

1. Documentation of Nontax Purposes. Saving taxes should not be the overriding primary purpose. Establish significant non-tax purposes.
2. Avoid Non Pro Rata Distributions for Paying Personal Expenses.
3. Keeping Sufficient Assets to Pay Living Expense is not a Safe Harbor around IRC §2036(a)(1). Client should retain sufficient assets to maintain standard of living to life expectancy, and perhaps beyond, without regard to entity distributions; however, this alone will not shield the client from IRC §2036(a)(1) exposure.
4. Follow the Partnership Formalities. If the client is not a general partner, make sure client is not in control of the partnership checkbook.
5. Involve Others in Negotiations. Meaningful negotiations are important when partnerships are created. Evidence of an arm's length transaction, *e.g.*, consider separate counsel for senior and junior family members.
6. Consider Ceding Control or Having a Third Party With Significant Ownership Interest.

7. Investment Changes. After the partnership is created, consider changes in the investment mix.
8. Insulate Spendthrift From Distribution Decisions. Do not name the person with creditor concerns as the general partner, if a purpose of creating the partnership is creditor protection.
9. File Protective Claims for Refund if Gain Recognized Attributable to Hard to Value Assets in an Estate. If gain is recognized with respect to the sale of partnership assets, file a protective claim in the event an estate tax audit results in an increased value which would result in an increase in the partner's basis.
10. Consider using a state law partnership which is not a partnership for federal income tax purposes.
11. Structuring a family partnership that is a partnership for state law purposes, but a single member LLC for federal income tax purposes - inside or outside the box planning?

h. ***Estate of Mitchell*, TC Memo 2011-94.**

i. On the estate tax return, the estate valued the 95-percent interests in the real properties owned by a trust and the 5-percent interests gifted to a children's trust. The parties stipulated that the interest should be based on each property's 100% interest discounted by stipulated fractional amounts.

ii. The Tax Court rejected a novel lease buyout approach used by the IRS's expert in valuing the underlying properties that were subject to long-term leases; rather, the court adopted the approach of the estate's experts-income capitalization method to value the properties.

iii. Additionally, the court reviewed certain pieces of art included in the estate which the IRS contested the values were higher.

1. The court rejected the IRS's art expert's opinion, who's valuation was substantially higher than the taxpayer's expert's and the IRS Art Panel's valuation of several pieces of art.

i. ***Petter v. Comm'r*, TC Memo 2009-280, 108 AFTR 2d 2011-5593.**

i. Tax Court Case: Petter involved inter vivos gifts and sales to grantor trusts using defined value clauses to limit potential gift tax exposure.

1. The gift document assigned a block of LLC units and allocated the first units to the grantor trusts up to the *maximum amount that could pass free of gift tax*, with the balance allocated to charities.
2. The sale document assigned a larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts in exchange for 20 year secured notes, and allocating the balance to charities. The units, for both gifts and sales, were initially allocated based on an appraisal conducted by a reputable independent appraiser.

3. The IRS argued that the initial allocation was based on inappropriate low values and lower discounts should have been applied. While the IRS and taxpayer agreed on applying a 35% discount, the IRS still challenged the transfers based on public policy grounds in connection with formula allocation provisions for gift tax purposes.
4. The Court held that formula allocation provisions do not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to the charity based on the final values determined for gift tax purposes.

ii. Ninth Circuit Court of Appeals Affirmation.

1. The IRS dropped the public policy argument and asserted that the part of the gifts attributable to charitable foundations were subject to a condition precedent, an IRS audit, in violation of Treas. Reg. §25.2522(c)-3(b)(1).
2. The appellate court rejected this argument.

j. Estate of *Giustina v. Comm'r,* T.C. Memo 2011-141.

i. The Tax Court determined that there were two appropriate methods for valuing the partnership interest. The cashflow method was based upon how much cash the partnership would be expected to earn if it had continued its ongoing forestry operations. The asset method was based upon the value of the partnership's assets if they were sold.

ii. The court found that the percentage weight accorded to the cashflow method should be equal to the probability that the partnership would continue to be operated as a timber company. The court determined that this probability was 75 percent. The court also determined the appropriateness of certain discounts applied by the parties' appraisers, and reached a valuation for the partnership interest of $ 27,454,115.

iii. Imposition of IRC §6662 penalty was not appropriate because the executor hired a lawyer to prepare the estate tax return, who hired an appraiser. Even though the appraisal did not incorporate the asset method, it was reasonable for the executor to rely on it, as it was reasonable to conclude that the partnership would continue to maintain its timberland assets without liquidating them.

k. IRS Estate and Gift Tax Audits.

i. The number of Federal estate tax filings has been declining since 2001.

ii. Since 2001, however, the Internal Revenue Service's audit coverage rate of Federal estate tax returns has been increasing. Practitioners should

change their assumptions from Federal estate tax returns "may be audited" to "will be audited."

iii. The IRS has hired additional estate tax attorneys. Thus, the audit rate will be increasing.

iv. Audits are being conducted under a national program making face to face meetings with an IRS attorney less likely.

v. 95% of audits are resolved at the audit level and 95% of cases that go to appeals are also resolved without the need for a court proceeding.

vi. Artwork with a value in excess of $20,000 is submitted to an Art Advisory Panel that meets twice a year. Must go to court to challenge their valuations.

vii. Planning Pointer: The IRS's *Statistics of Income Bulletin* released October 4, 2011 provides that 15,191 estate tax returns were filed in 2010, compared with 33,515 for 2009; this is a drop of 55%! Consider the increased likelihood of audits with an increased number of estate tax attorneys hired by the IRS and the lower number of estate tax returns filed in 2010.

l. Unbundling of Investment Advisory Fees: Proposed Regulation 1.67-4.

i. On September 7, 2011, Prop. Reg. 1.67-4, requiring trustees to unbundle their fees and defining a boundless range of coasts that would be subject to the 2% floor on miscellaneous itemized deductions. Corporate trustee fees are required to be unbundled between fully deductible services. *See Knight v. Commissioner*, 128 S. Ct. 782 (2008) and the proposed regulations under IRC §67(e). Highlights of the new proposed regulations include the following:

1. The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "***commonly or customarily would be incurred by a hypothetical individual holding the same property***."
2. The "commonly or customarily incurred" determination is made by the type of product or service actually rendered rather than the description of the cost.
3. "Commonly or customarily" incurred expenses that are subject to the 2% floor include costs in defense of a claim against the estate that are unrelated to the existence or administration of the estate or trust.
4. "Ownership costs" that are normally incurred by any owner of a property (such as HOA fees, real estate taxes, insurance premiums) are subject to the 2% floor.

5. A safe harbor is provided for tax return preparation costs:
    a. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor.
    b. Costs of preparing all other returns are subject to the two-percent floor.
6. Investment advisory fees for trusts or estates are generally subject to the two-percent floor except for additional fees (above what is normally charged to individuals) that are attributable to "an unusual investment objective" or "the need for a specialized balancing of the interests of various parties."
    a. However, if an investment advisor charges an extra fee to a trust or estate because of the need to balance the varying interests of current beneficiaries and remaindermen, those extra charges are not subject to the two-percent floor.
7. Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
8. A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance of the bundled fee is not subject to the 2% floor.
9. If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the two-percent floor, that portion of the bundled fee will be subject to the 2% floor.
10. Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requests comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS is particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

ii. IRS has not issued Final Regulations for IRC §67(e).

m. Consider Structuring Real Estate Entrepreneurs' Business in a Manner to Qualify for IRC §6166 Relief In Light of Recent IRS Rulings.

n. Grantor Trust Power of Substitution and Toggling.

i. Approval of use of the power of substitution in a non-fiduciary capacity as the grantor trust power. Rev. Rul. 2008-22. Be careful using the substitution power in an ILIT because could cause incidents of ownership in the life insurance policy. A revenue ruling clarifying this issue is anticipated to be promulgated in the near future.

ii. Toggling. Can turn off grantor trust status by including language that the grantor can release the grantor trust power. A different party can hold the power to restart the grantor trust status by giving the power back to the grantor. (Person releasing the power should not be same person who can restart the power). Be careful turning the power off and on, begins to look like a retained power under IRC 2036.

o. Valuation of S-Corporations – Tax-Affecting S Corporation Earnings.

i. A valuation issue that should be noted concerns the appropriateness of tax-affecting the earnings of S corporations. A common element of these entities is they do not pay income taxes on their entity-level earnings. Taxes are paid only at the shareholder level, which is in contrast to the situation with a C corporation where taxes are paid at the corporate level on the corporate earnings and then again at the shareholder level on any dividends paid to shareholders.

ii. A frequent practice among business valuation professionals has been to "tax-affect" the earnings of S corporations by applying C corporation tax rates to the results obtained.

iii. In 1999, a gift tax case (Gross v. Commissioner, T.C. Memo 1999-254 (T.C. 1999)), which was upheld on appeal (Gross v. Commissioner of Internal Revenue, 272 F.3d 333 (6th Cir. 2001)), held that tax-affecting S corporation earnings was not correct.

1. The major disagreement in Gross, involved the tax-affecting of the discounted cash flows of the company used to estimate value by the income valuation approach. The taxpayer's expert tax-affected (reduced) the S corporation's earnings by assuming a hypothetical 40% tax rate on the company's earnings under the discounted cash flow model. This was done even though the company did not pay a corporate level tax. The IRS's expert did not tax-affect the earnings of the S corporation.
2. The Tax Court ruled in favor of the IRS. The three judge panel at the Court of Appeals decided that tax-affecting was not appropriate by a narrow two-to-one vote.

3. The fact pattern in Gross was favorable to the IRS's position:
    a. The corporation was stable and had profitable operations;
    b. The corporation had paid out 100% of net income to the shareholders on an annual basis, ensuring that the shareholders would have enough cash on hand to pay their pro-rate share of income tax liability;
    c. Restrictive agreements made breaking the S election extremely difficult;
    d. No indication from ownership that S election would be broken; and
    e. The interest at issue was a minority interest.

iv. The taxpayer's business valuation expert argued that it is proper to tax-affect earnings for the following reasons:
    1. Tax-affecting was the generally accepted practice in the business appraisal community in valuing a minority interest in S corporations;
    2. S corporations sacrifice growth opportunities and capital appreciation in exchange for current income;
    3. S corporation shareholders are at risk that the corporation might not distribute enough income to cover shareholder liabilities;
    4. S corporations are susceptible to losing its "S" status (i.e.- What if the only reasonable hypothetical buyer was a C corporation);
    5. Tax-affecting has been specifically approved by the Tax Court (Maris, 41 TCM 127 (1980) and Hall, TC Memo 1980-4444);
    6. The IRS has implicitly endorsed the policy of tax-affecting in valuing stock of S corporations, particularly in two internal IRS documents (*IRS Valuation Guide for Income, Estate and Gift Taxes* and *IRS Examination Technique Handbook*).

v. To put the Gross decision into context, assume an estate that has a minority interest in an S corporation and the IRS has valued the decedent's interest more than 200% greater than the appraised Form 706 value because of the tax-affecting differential.
    1. Examples: Company C and Company S are two identical companies in the same line of business, with identical revenues and expenses. Company C is a C corporation that pays taxes on its corporate level income and Company S has made a subchapter S election (no corporate level income tax and the shareholders pay tax on the corporate level income). Assume a 20% Capitalization Rate for illustrative purposes.

IMPACT OF TAX AFFECTING		
	Company C	**Company S**
Revenues	$10,000,000	$10,000,000
Less Expenses	-$8,000,000	-$8,000,000
Equals Pre-Tax Profits	$2,000,000	$2,000,000
Corporate Tax Rate	40%	0%
Less Corporate Level Income Tax	-$800,000	$0
Equals Net Income	$1,200,000	$2,000,000
Divided by: Capitalization Rate	20%	20%
Equals Basis Value	$6,000,000	$10,000,000

2. The Value of Company S is $10,000,000 while the value of the Company C is $6,000,000. Both companies are identical besides the tax structure, yet Company S is worth 66.7% more than Company C merely because of the S election. The key point is the IRS does not consider the fact that the shareholders of an S corporation pay a shareholder level income tax (which could be a high as 39.6% in 2011) which could be approximately the same amount as the corporate income tax the C corporation pays.
3. In 2006, the Court of Chancery of Delaware, ruled that tax-affecting was appropriate (Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006)). Additionally, in Ringgold Telephone Company v. Commissioner of Internal Revenue, TC Memo 2010-103, both experts tax affected the subject S corporation's income using C corporation income tax rates. According to the taxpayer's expert, the trial occurred during December 2008, well after the controversial Tax Court decisions asserting that tax affecting S corporation income is inappropriate, yet the issues was not discussed at trial. The absence of an IRS challenge on this issue should not be overlooked.
4. Although the 6th Circuit Court of Appeals is not precedent in other circuits, the IRS appears to be applying the Gross principles in their review of gift and estate tax returns involving S corporations. The best way to deal with the tax-affecting issue is on a case-by-case basis.

VIII. Florida Legislative Update. In April of 2011, the Florida legislature enacted several significant changes to the probate and trust code, which was signed by Governor Scott on June 21, 2011. The legislation creates or modifies the following:

a. Intestate Succession: Effective October 1, 2011, Fla. Stat. §732.102(2) provides that the intestate share of a surviving spouse of a decedent, where all of the decedent's descendants are also descendants of the surviving spouse (or no

descendants) is the entire estate. Fla. Stat. §732.102(4) provides that if the surviving spouse has descendants that are also the decedent's descendants and has descendants not related to the decedent, then the surviving spouse's intestate share is half of the estate.

b. Reformation of a Will: Fla. Stats. §§732.615 and 732.616 essentially mirror Fla. Stats. §§736.0415 and 736.0416 (Florida Trust Code) to permit reformation of a will to correct a mistake and to modify a will to achieve a testator's tax objectives.

1. Fla. Stat. §732.615 permits an interested person to seek reformation of the terms of a will to conform to the testator's intent, which needs to be proved by clear and convincing evidence.
2. Fla. Stat. §732.616 allows an interested person to seek reformation of the terms of a will to accomplish the testator's tax objectives, in a way that is not contrary to the testator's probable intent.
3. Fla. Stat. §732.1061 provides that the court must award attorney's fees and costs to the prevailing party in an action under reformation of a will to correct a mistake and modification of a will to achieve tax objectives.
4. Challenges to Revocation of a Will and Trust: Fla. Stats. §§732.5165 and 736.0406 are amended to provide that revocation of a will or trust is void if procured by undue influence, fraud, duress or mistake. A challenge cannot take place until the instrument is irrevocable or the settlor's demise.

c. Attorney-Client Privilege Relating to Fiduciaries: Clarifies and expands existing law so that communication between a fiduciary client and the attorney is confidential and privileged. Fla. Stats. §§733.212(2)(b) and 736.0813 are amended by creating new reporting requirements for personal representatives and trustees compelling them to provide notice to the beneficiaries that an attorney-client privilege exists between a fiduciary and the attorney employed by the fiduciary.

IX. Ways to Reduce the Possibility of a Beneficiary Challenging the Estate.

a. Delaware Law Governs the Trust Instrument. Delaware law provides that an action to contest a trust cannot be initiated if not made before 120 days after the trustee provides written notice, to the person who is contesting, of the trustee's name and address, of whether such person is a beneficiary, and of the time allowed under this section for initiating an action to contest the trust. An advantage of this strategy is that if the trustee exercises his/her discretion to serve this notice on the trust beneficiaries while the settlor is still alive, the settlor would be able to testify during any judicial proceeding. Additional notice would be required each time a settlor amends his/her trust, which would start the

commencement of a new 120 day contest period. To qualify for this strategy a trust company with Delaware offices must be named as a co-trustee.

b. Provide that the Trust Will Be Governed by a State That Enforces In Torrorem Clauses Without Reasonable Exceptions. To qualify for this strategy, a trust company with offices in the state that will govern the trust must be named as co-trustee. A strategy to plan around a state law providing in terrorem clauses are unenforceable is including a provision in the trust that if the beneficiary has no valid prenuptial or postnuptial agreement then the vesting rights of the beneficiary are deferred (but not completely eliminated).

c. Videotape the Execution of the Testamentary Instrument.

d. Use Other Attorneys or Professionals as Witnesses to the Execution of the Documents To Provide More Credible Testimony on Questions of Capacity.

e. Have the Witnesses Join a Meeting with the Client Prior to Execution of the Testamentary Instrument.

f. Arrange a Medical or Mental Capacity Examination to be Conducted On or Near the Execution of the Instrument.

g. If a Concern Exists that a Claim of Undue Influence May be Made, or if Certain Beneficiaries are Being More Generously Provided For in the Instrument, Then a Statement May Be Included in Settlor's Trust Setting Forth That a Larger Gift Has Been Provided After Careful Consideration and That the Beneficiary of the Larger Gift Has Not Influenced Settlor.

h. Have Client Write Letter to Attorney Requesting the Attorney to Include Certain Provisions in the Testamentary Instrument.

i. Have Client Execute a Series of Testamentary Instruments Over a Period of Time. The result would be to force a contestant to challenge each Instrument, which would be both expensive and more difficult.

X. Putting the Team Together.

a. Who Are the Players? The attorney, accountant, investment advisor, insurance professional, family counselor, family office director, succession planner and trustee. Make sure the players who have excellent reputations and are experienced problem solvers in the wealthy client arena. For example, the insurance professional should be experienced in engineering insurance products to meet the needs of ultra high net worth individuals.

b. Loyalty and Existing Relationship vs. the Need for Expertise. Remember, it is Always Easier to Make Some One Look Bad Than it is to Make Them Look Good. Remember, Remember, Clients Never Forget a Bad Referral.

c. How Do You Make it Work? Communicate, have a quarterback, and have the client buy in to the team approach.

d. Team Meeting Should Occur Annually to Review Estate Plan, Performance of Assets, Changes in Family Dynamics, Changes in Trust and Tax Laws, Compliance with Details to Avoid Responsibilities Falling Through the Cracks, Monitor Professionals to Make Be Certain They Are Doing Their Jobs.

EXHIBIT "A"

TAX LAW

by Domenick R. Lioce

Chinks in the Armor: Current Trends in Limited Liability Company Structure After *Olmstead*

From corporations to limited partnerships and limited liability companies, developing trends in the law shape the dynamics of an entity's limited liability. Certain corporate forms provide more protection from outside creditors than others. This article will examine a few of these entities and see where chinks in the armor exist, allowing outside creditors to reach seemingly protected assets.

Insulation Against Inside Liabilities

For over 100 years, we have witnessed the existence of corporations. One of the main benefits of a corporation is to use an entity to own assets or operate a business and shield corporate owner(s)' other assets from third-party claims against the entity. We call this "insulation against inside liabilities." When we go beyond this infrastructure and "pierce the corporate veil," the question arises: Do such claims against the corporation reach its shareholders? The answers lie in the instrumentality rule and identity rule.

The instrumentality rule requires a plaintiff to prove the following three elements against shareholders: 1) complete dominion and control of the entity's policy and business practices; 2) use of such control to commit fraud or wrongdoing, breach of a legal duty, or a dishonest or unjust act; and 3) such control and breach of duty proximately caused injustice or loss.[1] One example of a dishonest or unjust act for proof of the second element occurs when shareholders use control to avoid personal liability that an individual previously assumed.[2] When two corporations are really controlled as an entity due to common owners, officers, directors, or shareholders, the identity rule generally governs.[3] A court will also use the identity rule to pierce the corporate veil when two corporate entities fail to observe corporate formalities.[4]

Limited liability companies (LLCs), which have only been around since 1982, gained popularity in Florida after the 1999 repeal of the Florida corporation income tax on an LLC's income and later repeal of the Florida intangible tax on an LLC's interests. Limited liability limited partnerships (LLLPs) arose when the legislature amended the LLLP statute to provide for *limited* liability protection for all partners, including general partners rather than partial limited liability formerly available.[5] A Connecticut court held under the appropriate circumstances it could pierce the corporate veil of an LLC and hold members personally liable to third parties. In *Stone v. Frederick Hobby Associates II, LLC*, No. CV 000181620S, 2001 WL 861822 at *10 (Conn. Super. Ct. July 10, 2001), the court found, based on the facts, the "instrumentality and identity rules" allowed the court to pierce the veil of an LLC and hold individual members personally liable.

When one considers the big picture of piercing the veil of a corporation, LLC, or LLLP, a secondary question arises: How does a court pierce the veil of a subsidiary? A recent Florida case held that to pierce the veil of a subsidiary, a plaintiff must prove the subsidiary is a mere instrumentality of the parent company, *and* the parent company organized and used its subsidiary to mislead or perpetrate a fraud on creditors.[6]

The court in *Litchfield Asset Management Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2001), allowed "reverse veil piercing" or piercing the veil against a subsidiary. The court in *Litchfield* determined a judgment creditor could access an LLC's assets against the LLC's sole member.[7] After the court entered judgment against the debtor in her individual capacity, she set up two LLCs and contributed cash to both. The *Litchfield* court noted the LLCs never operated a business, made distributions, or paid salaries. Moreover, the debtor used the LLC's assets to pay personal expenses and make interest-free loans to family members. The court held that the debtor used control over the LLCs to perpetrate a wrongdoing against creditors, disregarded corporate formalities, and exceeded her management authority (via loans to family members). The court ordered reverse piercing of the LLCs.

Litchfield demonstrates certain flaws inherent in use of a single-member LLC as an asset protection vehicle. For example, in situations like *Litchfield*, a creditor's attorney may file a complaint alleging fraud and invoke the veil-piercing remedy, allowing the judgment creditor to circumvent normal judgment collection procedures codified in the LLC act.[8] One such procedure is charging of the member's interest in the LLC.[9]

Insulation Against Outside Liabilities

Limited partnerships and LLCs

share certain asset protection features against outside liabilities, such as a creditor. One key feature occurs when a limited partner cannot satisfy a creditor. The creditor's only available remedy may be to secure a charging order against a partner's limited partnership or membership interest income.[10] A charging order gives the creditor the right to receive all distributions from the LLC related to the debtor's interest thereon until such time as the debt is satisfied. Because limited partnerships and LLCs similarly insulate debtors from outside liabilities, the protection of the charging order concept should extend to LLCs in Florida.

In 2005, a Florida Bar task force successfully provided the Florida Legislature with a revised form of the Florida Revised Uniform Limited Partnership Act of 2005. Under RE-FRULPA, the exclusive remedy for a judgment creditor of a limited partnership is a "charging order."[11] LLCs currently enjoy the protection of "charging orders," but not as an exclusive remedy.

The Exclusivity of the Charging Order Remedy

Under RE-FRULPA, in an action against a limited partnership, charging orders provide an exclusive remedy when a judgment creditor's rights equal those of an assignee to the extent charged.[12] F.S. §608.433 provides similar protection for LLCs. However, unlike limited partnerships, under F.S. §620.1703, a charging order is not the *sole* remedy against an LLC interest.[13]

In an LLC, the rights of a creditor under a charging order equal those of a transferee and cannot reach management and other partners' rights.[14] The rights of the charging order holder extend only to the judgment debtor/partner's rights to distributions.[15] In this scenario, the rights of the charging order holder are analogous to those of a wage garnishor. The charging order represents a lien on the judgment-debtor's distribution rights. Such a right is the judgment-debtor's transferrable interest. A court cannot order other remedies for a judgment creditor who attempts to satisfy a judgment out of the judgment debtor's interest in the limited partnership.[16] This includes remedies of foreclosure on the partner's interest in the limited partnership or a transferee's transferable interest and a court order for directions, accounts, and inquiries that the debtor general or limited partner might have made.[17]

Certain state statutes and precedent provide for the foreclosure and sale of an LLC or limited partnership interest. In such a situation, the buyer takes the position of an assignee and shares no member or partner rights. For example, in *Crocker National Bank v. Perroton,* 208 Cal. App. 3d 1 (Cal. Dist. Ct. App. 1989), the California district court of appeal considered whether a charged limited partnership interest was subject to foreclosure and sale. The court determined that when the creditor has a "charging order," all partners other than the debtor agree to sale and the judgment remains unsatisfied, a court can authorize sale of the debtor's partnership interest.[18]

The *Nigri v. Lotz,* 453 S.E.2d 780 (Ga. Ct. App. 1995), decision illustrates the importance of the incorporation state in the entity selection process. As in *Nigri,* if the applicable limited partnership statute and case precedent do not make the charging order the sole remedy, the court may use other means to enforce the charging order, such as foreclosure of a partner's interest.[19] In *Nigri,* the Georgia court of appeals considered whether a charged limited partnership interest was subject to foreclosure and sale.[20] The court held that a trial court may enforce a charging order through foreclosure of a partner's interest, especially when it appears distributions under the charging order will not pay off the judgment debt within a reasonable period of time.[21] The court concluded whether a judicial sale of the charged partnership interest is appropriate in aid of a charging order lies within a trial court's discretion.[22]

Despite the ultimate decision in *Nigri,* the court raised an argument of concern. Noting the Uniform Limited Partnership Act (ULPA) and the Uniform Partnership Act (UPA) governed the limited partnership in *Nigri,* the court of appeals stated the UPA contained a provision which prohibited the sale of a charged interest, while the ULPA did not.[23] The court determined the purpose underlying the inability to sell and transfer a partner's charged interest under the UPA was fear of disruption as the creditor-assignee could seek judicial dissolution of the partnership.[24] The court distinguished foreclosures of limited partnership interests since the assignee of a limited partnership interest cannot seek judicial dissolution under the ULPA.[25] The bankruptcy court in *In re Albright,* 291 B.R. 538 (Bankr. D. Co. 2003), advanced the same argument. The bankrupt sole member in *Albright* sought to thwart the trustee's ability to reach the LLC's assets and use them for her own obligations.[26] The LLC member argued that according to the charging order, the only relief available to the trustee was receipt of distributions.[27] The court rejected the charging order defense on grounds that the remedy served to protect nondebtor members of a multi-member LLC from judgments against a debtor member.[28] Thus, in a single-member entity in which no nondebtor members existed, the trustee could take on a managerial position in the LLC in place of Albright.[29]

Single-member LLCs

In a single-member LLC, different considerations shape how a court applies liability rules. For example, in *Albright,* the court concluded a charging order's purpose was to protect other LLC members from sharing governance responsibilities with a judgment creditor.[30] The court found single-member LLCs with only one managing member were not protected since no other members existed.[31] In *Albright,* a judgment creditor could, thus, obtain governance rights.[32]

The *Albright* caveat — a Ch. 7 liquidated bankruptcy. Upon the debtor's bankruptcy filing, she effectively transferred her membership interest to the estate.[33] With no other existing members, the bankruptcy trustee became a substituted member.[34] Thus, the same result would not necessarily occur in favor of a creditor.[35] Certain elements of the LLC's statutory struc-

ture, including the charging order and requirement that the current owner approve new members, lose their rational support when viewed in the single-member LLC context.[36] Thus, *Albright* should not apply to multi-member LLCs.[37]

In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005), involved a recent bankruptcy court decision in which the court allowed a Ch. 7 bankruptcy trustee to step in the shoes of a bankrupt member of an Arizona LLC as a full member without assuming the assignee status of a transferee, which state law and the operating agreement required. There, the debtor's parents set up a multi-member family LLC and distributed significant funds to themselves and their children *but not* the debtor/bankruptcy trustee.[38]

In order to mitigate the *Ehmann* issue, tax planners recommend 1) drafting the LLC operating agreement or operating agreement as an "executory contract" for bankruptcy law purposes and provide entity owners' ongoing obligations; 2) mandatory capital calls; 3) service obligations; 4) noncompetition obligations; and 5) partnership or membership interests with owners of a trust or tenants by the entirety.[39]

In the single-member LLC context, how does a Ch. 11 bankruptcy proceeding differ from a Ch. 7 proceeding? Recent court decisions involving pending Ch. 11 bankruptcy actions relied entirely on bankruptcy law and held that in a single-member LLC, all debtor's interests became the bankruptcy estate's property and subject to the trustee's sole and exclusive authority.[40]

The Florida Supreme Court case of *Federal Trade Commission v. Olmstead*, 528 F.3d 1310 (11th Cir. 2008), provides an interesting analysis of how to reach single-member LLC assets in a fraud scenario. *Olmstead* involved two people who used an "S" corporation and single-member LLC to run a credit card scam.[41] The defendant agreed to appointment of a receiver over the LLC who was directed to "conserve, hold and manage, preserve the value of, and prevent the unauthorized transfer, withdrawal, or misapplication of the entities' assets."[42] The Federal Trade Commission (FTC) later obtained a $10 million judgment against the individuals and their original company.[43] The FTC then moved to compel defendants to surrender their single-member LLC interests to the receiver.[44] The district court granted the motion, and the receiver sold the LLC's assets and paid the FTC the proceeds.[45] The appellate court in *Olmstead* certified the following question to the Florida Supreme Court: "Whether, pursuant to Florida Statute section 608.433(4), a court may order a judgment-debtor to surrender all 'right title and interest' in the debtor's single-member limited liability company to satisfy an outstanding judgment?"[46]

The Florida Supreme Court held that a charging lien is not the sole remedy against a single-member LLC. It cited the "emptiness" of the charging lien when there are no other members to protect and/or obtain the approval to become a member. More importantly, the decision stated that the LLC statute did not have the "sole and exclusive" language that the limited partnership statute contained. Although the opinion spoke only to single-member LLCs, this last line of reasoning does not bode well for multi-member LLCs, but it does indicate that charging orders against limited partnership interests are the creditors' sole remedy.

On September 29, 2010, the U.S. District Court of Appeals for the 11th Circuit concluded that, based on the Florida Supreme Court's decision in *Olmstead*, a court may order a judgment-debtor to surrender all "right, title and interest" in the debtor's single-member LLC to satisfy a judgment creditor's claims.[47] Now we have federal appellate law to add to the Florida Supreme Court, as well as the four bankruptcy cases that all do away with the "soleness" of the charging order as a remedy for creditors against single-member LLCs.

Single-member LLCs Treated as Separate Entities

Can the IRS get a tax lien against a single-member LLC? An assessment against a single-member owner of an LLC does not result in an enforceable IRS tax lien against the LLC's assets.[48] In one case, the IRS treated a disregarded single-member LLC as a separate entity in order to apply the small partnership exception to TEFRA audit rules.[49]

As an interesting aside, in Revenue Ruling 77-137, the Internal Revenue Service ruled that a limited partnership entity's K-1 must be reported by a limited partnership interest assignee, even when the partnership agreement provided an assignee may not become a substituted limited partner without the general partners' consent.[50] This rule, applied to an LLC, gives a creditor a strong inducement against foreclosure, if documents fail to provide for minimum tax distributions.

A final thought regarding Florida law: RE-FRULPA currently provides the charging order as a *sole* remedy. Such exclusivity binds Florida courts as we move into the future. Unfortunately, LLCs do not share such tight protection. The new Florida Bar task force redrafting the LLC statute will review this inconsistency. But until a change takes place in the law, enough chinks in the armor of the LLC exist to allow outside creditors through. Thus, the safer structure in such a situation is a limited liability limited partnership.

Planning Ideas

While *Olmstead* is still fresh on our minds, consider the following planning thoughts:

1) Issue additional shares of the LLC so that the LLC is a multi-member LLC and not a single-member LLC. The only caveat is that the *Olmstead* case infers that the charging order is not the sole remedy against a multi-member, either, because the statute is improperly drafted. Assuming that the new statute goes through as currently drafted, it should be resolved by the middle of this year. However, in the meantime, you still have the question of whether it is the sole remedy based on the dicta in *Olmstead*.

2) Leave the state. However, the use of single-member entities in states with clearer language — such as Delaware or Wyoming — may not be as safe as you think. No rulings

have been held in these states, but it is pretty clear that the bankruptcy courts in *Albright, Ehman's,* etc. are not going to recognize the single-member LLC to protect against creditors. With all the discussion going on around the country about *Olmstead*, it may well be that the courts are not going to recognize a single-member LLC under state law either, so if you are going to leave, leave the country.

3) Hold the interest in a single-member LLC as tenants by the entirety between husband and spouse. It is strongly recommended that you issue a single certificate, labeled husband and wife as tenants by the entirety, and draft an operating agreement that clearly states the entity as a single-member entity, and there is no distinguishment between voting, profits and losses, or capital as between the spouses. Lastly, the personal tax returns of the spouses should be filed jointly disregarding the entity and recognizing all the income as if the entity were disregarded. In Florida, this should protect the assets against the creditor of one of the spouses and should be disregarded for tax purposes. However, you still have the following problems that occur:

- Client is single.
- Prenuptial or client may simply not want to share the ownership with his or her spouse.
- The judgment is against both spouses.
- If the wrong spouse dies.
- Divorce.
- This arrangement may not fit with your estate planning goals when you are trying to set up separate assets in each spouse's name to fund the unified credit shelter trust. Of course, if you have enough to fund that trust for each spouse with other assets, it is not as much of a problem.

4) The best alternative seems to be to use an "LLLP." Convert to or begin with an LLLP. The *Olmstead* court indicated that the "sole and exclusive" language of the LLLP statute was sufficient to protect the entity against debtors. This entity is a little more expensive and requires a partnership tax return. The only problems here are that you must have a real second member, and you must identify the general partner. The first problem is mostly a business question. As for the second, it can be a corporation, an LLC, or an individual. The creditor can take the interest of a corporation or an LLC and thereby own the general partner's interest, but an individual general partner may be best because the creditor can only obtain a charging lien against his or her interest, and the individual is protected from inside liability by elect-

ing to become an LLLP. Further, if the individual is married, the general partner interest could be held as tenants-by-the-entireties, which should avoid the charging lien entirely. After that, the creditor is a mere "assignee" and cannot affect the company business without the consent of the other partners. And the other partners can replace the general partner unless restricted by the partnership agreement, so in drafting the agreements, make sure to provide for the remaining partners to do so in the event of such an assignment.

Continued Uses for Single-member LLCs

The following uses presume that there is little or no need for protection against outside creditors:

1) As firewalls between the shareholder and another interest. For instance, in a tenancy in common (TIC), rather than taking the owner's undivided interest in the name of the individual and subjecting the person to liability, it is better to hold the interest in a single-member LLC so that it not only provides for protection from liability coming from the property, but also the entity is disregarded so it can use the entity to effect a tax-free exchange under §1031. This LLC can also be held jointly as tenants by the entirety as discussed above. Although this does not obviate *Olmstead*, it is better than holding the TIC in the individual's name.

2) Firewalls between subsidiaries and parent. When used as subsidiaries of a parent holding company, LLCs sometimes are used to create firewalls between the subsidiaries and the parent. The only time the *Olmstead* issue would arise would be debt at the parent level, which should be manageable if the parent is a simple holding company holding the subsidiaries.

3) Bankruptcy remote entities. The LLC is a good choice to serve as a bankruptcy remote entity. This means that the interest in capital and profits would be owned by the borrower, but a nonprofit/capital interest is owned by a lender or its nominee. That interest is a second class of membership interest, which only has the right to vote against such things as bankruptcy, lawsuits, adding additional debt, etc., which the lender would like to prevent. ❑

[1] *See Stone v. Frederick Hobby Assocs. II, LLC*, No. CV 000181620S, 2001 WL 861822 at *8 (Conn. Super. Ct. July 10, 2001).
[2] *Id.*
[3] *Id.* at *9.
[4] *Id.*
[5] FLA. STAT. §620.81002 (2010).
[6] *17315 Collins Ave., LLC v. Fortune Dev. Sales Corp.*, 34 So. 3d 166 (Fla. 3d D.C.A. 2010); *see also Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So. 2d 1114 (Fla. 1984) ("improper conduct" also required); *Baldwin v. Bill & Carolyn Ltd. P'ship*, No. BAP.NO. EO-05-114, 2006 WL 2034217 at *1 (B.A.P. 10th Cir. 2006).
[7] *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2001).
[8] FLA. STAT. §621.02 (2010). Professional Service Corporations and Limited Liability Company Act, Ch. 621, §621.02 (2010); *see* FLA. STAT. §608.701 (2010).
[9] FLA. STAT. §608.433 (2010). Professional Services Corporations and Limited Liability Companies, Ch. 621 §621.8504 (2010); *see also Klein v. Weidner*, No. 08-3798, 2010 WL 571800 at *8 (E.D. Pa. Feb. 17, 2010) (reverse pierce where LLC improperly used to perpetrate injustice against creditor); *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal. App. 4th 1510 (Cal. Ct. App. 2008) (reverse pierce allowed with "alter ego" doctrine after alternative available remedies found inadequate).
[10] FLA. STAT. §620.1703 (2005).
[11] *See* Rights of Creditor of Partner or Transferee. FLA. STAT. §620.1703 (2010).
[12] FLA. STAT. §620.1703(3) (2010); RE-FRULPA section citation providing judgment creditor exclusive remedy is charging order and rights are of an assignee to extent charged. FLA. STAT. §620.8504 (2010).
[13] *See* Right of an Assignee to Become Member. FLA. STAT. §608.433 (2010).
[14] FLA. STAT. §§608.432 and 608.433(4) (2010).
[15] FLA. STAT. §608.433(4) (2010).
[16] FLA. STAT. §620.1703(3) (2010).
[17] *Id.*
[18] *Id. See also Hellman v. Anderson*, 233 Cal. App. 3d 840 (Cal. Ct. App. 1991) (consent of nondebtor partners not always required when no undue interference with partnership business exists).
[19] *Nigri v. Lotz*, 453 S.E.2d 780, 782-783 (Ga. Ct. App. 1995).
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.* Similarly, other states with statutes or precedent allowing foreclosures include California, Colorado, Connecticut, Georgia, Hawaii, Idaho (effective July 1, 2010), Illinois, Iowa, Kansas, Kentucky, Maryland, Missouri, Montana, Nebraska, New Hampshire, Ohio, South Carolina, Utah, Vermont, and West Virginia. States not allowing foreclosure include Alabama, Alaska, Arizona, Delaware, Florida, Minnesota, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, Virginia, and Wyoming.
[26] *In re Albright*, 291 B.R. 538 (Bankr. D. Co. 2003).
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *See also In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *Crocker Nat'l Bank v. Perroton*, 208 Cal. App. 3d 1 (Cal. Dist. Ct. App. 1989); *cf.* Revised Model LLC Act, FLA. STAT. §621.02 (2010) (permits foreclosure on multi-member LLC interest as in *Perroton* and *Nigri*, 453 S.E.2d 780 at 782-783); *see also* The Florida Bar task force drafting the new Florida LLC Act and reviewing single- and multi-member issues.
[38] *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005).
[39] In Florida, "tenants by the entirety" gives property owners significant asset protection, as husband and wife theoretically own 100 percent of the asset, which forbids one spouse's creditor from seizing the property. Exceptions are joint debt and when a nondebtor spouse dies with an action pending against the debtor spouse.
[40] *In re Modanlo*, 412 B.R. 715 (Bankr. D. Md. 2006), *aff'd* 266 Fed. Appx. 272 (2008); *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006).
[41] *Federal Trade Comm'n v. Olmstead*, 528 F.3d 1310 (11th Cir. 2008).
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Federal Trade Comm'n v. Olmstead*, 621 F.3d 1327 (11th Cir. 2010).
[48] *IRS CCA* 200338012, 2003 WL 22208688, §82.01.00-00 Trust Fund Taxes: Collection (Sept. 19, 2003); *IRS CCA* 200235023, WL 1999524, §6331 Levy and Distraint (Aug. 30, 2002).
[49] *See IRS CCA* 200250012, 2002 WL 31781355, §6231 Definitions and Special Rules (December 13, 2002).
[50] REV. RUL. 77-137, 1977-1 CB 178.

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This column is submitted on behalf of the Tax Section, Guy E. Whitesman, chair, and Michael D. Miller and Benjamin Jablow, editors.

Exhibit A-1

Business Succession Planning

Husband and Wife operate two hotels. Hotel I is owned by the family business, an S Corporation, and Husband and Wife are the sole shareholders. Hotel II is held in their individual names and is leased to the S Corporation. Both hotels are run by their two Daughters through the S Corporation. The S Corporation also holds several properties that collectively constitute a tree farm, plus Husband and Wife own an additional tree farm.

Suggested steps for the client:

1. Recapitalize the S Corporation and create non-voting stock which will be gifted to the Daughters.

2. Afterwards, form a new LLC within the S Corporation to hold the tree farms.

3. Spin off the tree farm LLC to the then-existing shareholders of the S Corporation. Husband and Wife are the Managing Members, and the Daughters are Limited Members (Husband, Wife and Daughters all have the same interests in the property both before and after, so no gift).

4. Husband and Wife then deed their separate tree farm to the LLC, causing a gift to be recognized in the amount of 90% of the fair market value of the property.

5. Form new FLLLP to hold Hotel II currently held in individual names, transfer hotel to the new FLLLP.

6. Gift the limited partnership interests in new entity from Husband and Wife to Daughter 1 and Daughter 2.

Exhibit A-2

Business Succession Planning

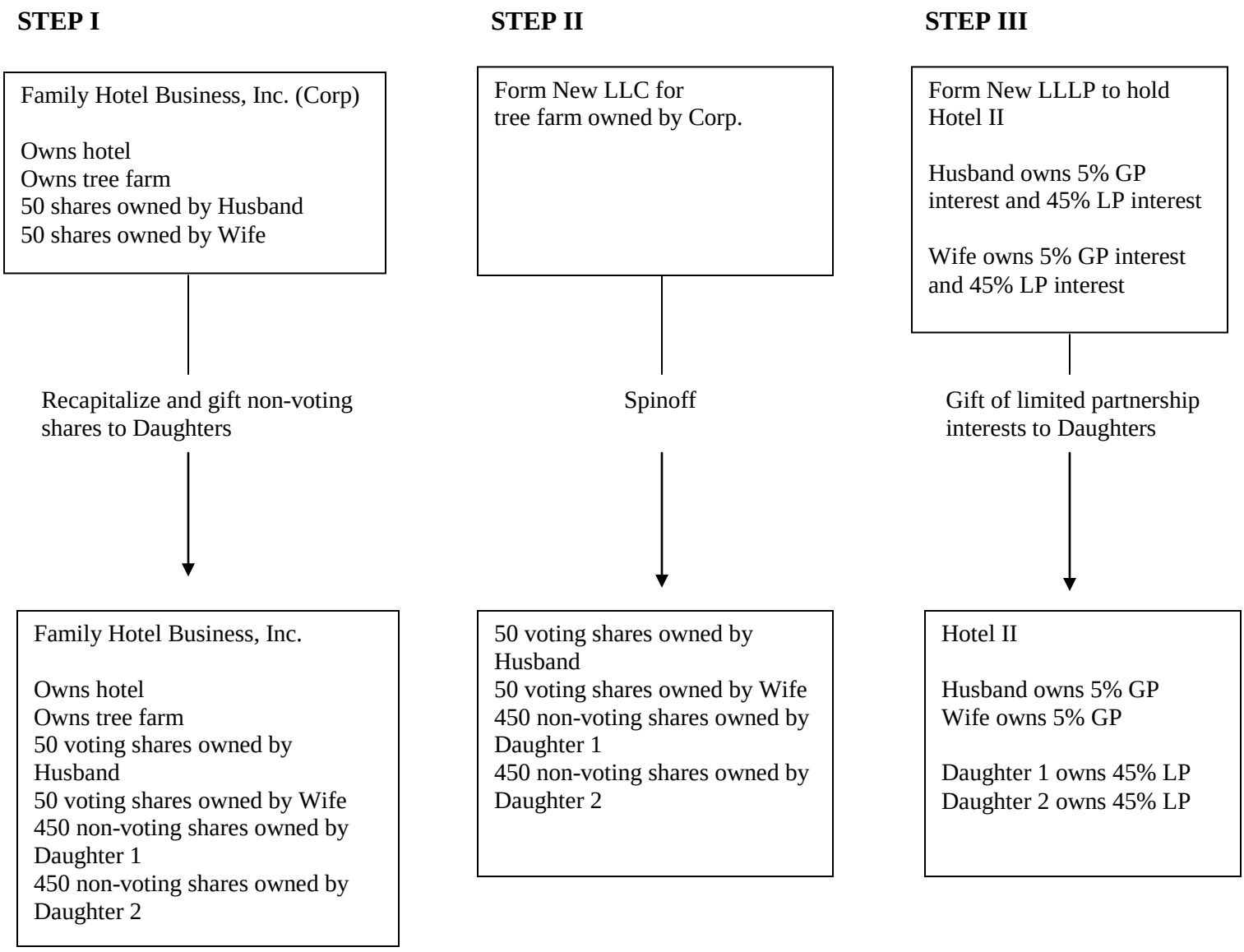

Exhibit "B"

ESOPS – EMPLOYEE STOCK OWNERSHIP PLAN

PRESENTED AT THE FICPA

2011 ESTATE AND FINANCIAL PLANNING CONFERENCE

December 2, 2011

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This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time, so some parts may be less current than others. The authors invite suggested changes for future presentations. The views expressed herein are not necessarily those of Nason, Yeager, Gerson, White & Lioce, P.A. or Comiter, Singer, Baseman & Braun, LLP. Any tax advice contained in these materials was not intended or written by authors to be used and it cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the tax payer and cannot be used as a basis for a tax return reporting position. Any tax advice contained in these materials was written to support, within the meaning of Treasury Department Circular 230, the promotion or marketing of the transactions or matters addressed by such advice because the authors have reason to believe that it may be referred to by another person in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayers. Before using any tax advice contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

TABLE OF CONTENTS

Exhibits

I. INTRODUCTION.

ESOP's are a tax-advantaged tool extremely valuable in business succession planning. It is often the best vehicle under the right circumstances to sell a business, particularly where the market is soft or non-existent. It may also be useful in acquisitions of other companies or assets

An ESOP is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the employer company. While it is subject to all of the general pension plan rules under the Internal Revenue Code ("IRC") and ERISA, an ESOP has some very specific advantages.

1. An ESOP can purchase employer stock from the employer or its shareholders.

2. An ESOP can borrow money from or on the credit of the employer to fund the plan. (Other pension plans cannot borrow money to invest). IRC § 4975(d)(3); ERISA § 409(b)(3).

3. It can be funded with the contribution of stock or any combination of cash or debt to finance the purchase of such stock.

II. USES.

1. Use tax-deductible corporate earnings to buy shares from owners of closely-held companies at long term capital gain rates on a deferred basis.

2. Create a market for inside and/or outside shareholders in closely-held companies.

3. Create business succession opportunity.

4. To finance corporate acquisitions using pretax dollars (see example on Exhibit "D").

5. To enhance corporate performance and job satisfaction by:

   - creating a corporate "ownership" culture;
   - relieving the corporation of corporate tax entirely when utilizing an "S" corporation (available under IRC § 1361 since 1996 and IRC § 512(2) since 1998 re UBI);
   - provide a reward to employees with a substantial retirement benefit.

6. Estate planning and charitable giving

7. To refinance existing corporate debt by selling newly issued stock to an ESOP which uses debt financing. See PLR. 9530053, 9649050 and 9652024.

III. TAX ADVANTAGES.

1. Employees are not taxed until they receive distributions.

2. Employer can deduct:

   - contributions to the plan up to 25% of payroll (IRC § 409(a)(9)(A);
   - principal and interest on loans used to buy the employer stock;
   - under IRC § 404(K), cash dividends paid on stock owned by the ESOP, so long as the dividends are used to
     - (i) passed through to pension beneficiaries;
     - (ii) to service debt used to by employer stock;
     - (iii) buy employer stock;
   - Life insurance premiums on policies on the life of Seller utilized to payoff the purchase money note.

3. The seller can defer gain recognition under IRC § 1042 (so long as the ESOP owns at least 30% of the employer's stock), by reinvesting the sale proceeds in certain permitted stocks, bonds or other securities of U.S. operating companies. (see Section V below)

4. S corporations income flows through to its shareholder, which is a tax-exempt pension plan. Hence, neither the S corporation nor its shareholder will be subject to federal income tax. This provides the corporation with significantly more cash available for growth and debt service.

5. Multiple entity businesses, such as homebuilders, can avoid ordinary income by reorganizing the entities into one (or a holding company). See Exhibit "A". This also provides the selling shareholder with a higher value for his stock since more assets are combined together. CAVEAT: "Step-transaction" theory.

IV. LEVERAGING.

1. A non-leveraged ESOP is one in which the employer corporation contributes its stock (treasury stock or newly issued stock) to the Plan up to 25% of covered payroll. The employer corporation gets a tax deduction equal to the fair market value of the stock contributed.

2. A leveraged ESOP borrows all or a portion of the amount needed to purchase company stock. The borrowing can be from the selling purchaser-- either a stockholder or the corporation itself; it can borrow from a third-party lender using the purchased stock as collateral or the credit of the employer; or it can be a combination of both. The company establishes an ESOP trust, which borrows money from the lender with a company guarantee. (In practice,

lenders usually prefer lending to the company, which in turn lends the funds to the ESOP.) The ESOP trust buys stock from shareholders and holds it in a suspense account. The company makes yearly tax-deductible contributions to the ESOP, which in turn pays off the loan. As the loan is paid off, shares of stock are released form the suspense account into individual employee accounts. Employees receive their vested account balances when they retire or otherwise leave the company. (See Exhibit "B".)

3. In most situations where there is not an outside lender financing the purchase, the selling shareholder desires a shorter payout period than the term of the contributions to the ESOP. This also occurs where the company has high cash flow but a lower contribution amount due to a smaller number of employees and smaller payroll amount. To accomplish this, the Corporation may first redeem the shareholder with cash and/or a note that the company's cash flow can safely support. The company then sells shares to the ESOP with a note payable over a longer period of time. This portion is "cashless" since the contribution is the same as the ESOP note payment back to the company. (See Exhibit "C".)

CAVEAT: While a Seller note qualifies for installment treatment under IRC § 453, it must comply with the "toll charge" defined under IRC § 453A if the note is more than $5 million.

V. QUALIFIED REPLACEMENT ROLLOVER.

Under IRC § 1042, the owner of a closely held C corporation (S corporations do not qualify) can defer gain recognition on the sale of stock to an ESOP so long as:

1. The ESOP owns at least 30% of each class of outstanding stock (excluding non-convertible, non-voting preferred stock) of the employer corporation. (Two or more owners combined can meet the 30% test).

2. The seller reinvests the sale proceeds into Qualified Replacement Property during the period from 3 months before to 12 months after the sale.

"Qualified Replacement Property" ("QRP") includes stocks, bonds or other securities of U.S. operating companies. Among others, its does not include government bonds, mutual funds, REITS, partnerships or limited liability company interests.

Any of the proceeds not reinvested in QRP is recognized as long term capital gain.

PLANNING NOTE: If the selling shareholder complies with the requirements of IRC § 1042, and holds the QRP until death, the tax on the stock sold is avoided because the heirs receive a stepped-up basis.[Assuming Congress reinstates the Estate Tax provisions]

NOTE: Even though the gain on the sale of the shares is not taxed, all interest received on an installment note is recognized as ordinary income.

CAVEAT: Gain is deferred until such time as 1042 securities are resold. If the ESOP sells the shares within 3 years after the sale, the employer may be subject to a 10% excise tax.

PLANNING NOTE: Some wealth advisors offer a program where the selling shareholder can buy long term (usually 30 years) from very strong and stable public companies which qualify for 1042 tax deferral. Then shareholder then borrows against these long term notes and invests in a diversified portfolio that can be bought and sold without triggering the 1042 deferred gain and the excise tax.

VI. MANAGEMENT CONTROL.

1. The ESOP must be operated for the exclusive benefit of the Plan participants. IRC § 401(a)(2). The ESOP is governed by a trustee. The trustee can be anyone, including the selling shareholder, an officer or director. However, due to the fiduciary liability and inherent conflicts of interest, it is best to hire an independent fiduciary.

2. Generally, the trustee votes the ESOP shares. See IRC § 409(e)(2); Rev. Rul. 95-57, 1995-2 C.B.62. Voting can be given to the vested participants, but it is rarely done.

3. Control of the operations of the corporation is really in the hands of the directors and the officers, which is usually controlled by the selling stockholder where seller financing exists and when the ESOP is funded over time.

4. During the term of the seller note in a leveraged transaction, the seller can maintain his position as CEO, control the board and be secured by company stock and company assets.

VII. UNFUNDED LIABILITY.

Upon retirement, employees of a closely-held company usually opt to receive cash for their retirement instead of stock. This liability can be substantial in the case of a leveraged transaction since the agreements usually provide a restriction of cash distributions from the ESOP until the seller's note is repaid. The company should establish a sinking fund, either through an insurance policy and/or in combination with an investment fund to provide for this liability. If an insurance policy on the selling shareholder is insufficient to cover the unfunded liability, the company can use policies on key employees can be used as well, or it can simply create a sinking fund to cover the remainder of the shortfall.

VIII. WARRANTS.

In order to reduce the interest rate borne by the ESOP via the seller note by reducing the rate of return to the selling shareholder below market, the company can issue warrants to the seller at the same or greater price than the ESOP is paying for the stock. Assuming the company's stock value increases in the future, the seller can sell the warrants back to the company at a profit and thus retain a market interest rate of return.

IX. ESTATE PLANNING.

1. The company should purchase insurance on the life of the selling shareholder(s) to provide:

(a) Liquidity for the deceased shareholder's estate;

(b) Relieve the ESOP from the burden of payment of the note; and

(c) By using a universal or whole life policy, in the event of the survival of the seller, the company will accumulate a sinking fund to pay the unfunded liability described under the ESOP.

2. The seller notes can be contributed to a family limited partnership ("FLP"). When gifting the limited partnership interests to the seller's heirs, discounts are realized for both the note itself because it is long term, weakly secured and has a below market interest rate, PLUS the usual discounts for lack of marketability, transfer restrictions, etc. All or some of the limited partnership interest can be reduced further (or even zeroed out) by contributing them to a Grantor Retained Annuity Trust ("GRAT"). See Exhibit "E".

3. The warrants usually have a nominal value at issuance because the company stock value must increase before the warrants have value, and the warrants cannot be exercised until after the seller note is paid in full. As the company increases its value by both paying off the seller note and increasing its profitability, the warrants increase in value. The warrants can be contributed to a FLP as well. The nominal value of the warrants combined with the value discounts associated with the limited partnership interests result in little or no need to use up the seller's lifetime gift exemption. Meanwhile, increasing value of the warrants is kept out of the seller's estate.

X. BASIC PLAN RULES. (See Pension Consultant)

1. Contribution Limits: Generally, 25% of covered payroll. IRC § 404(a)(3). For leveraged "C" corporation ESOP's, contributions are further limited to the cash contributions and principal only of ESOP loans paid that year. IRC § 404(a)(9). "S" corporations can also deduct the interest on the ESOP loan. Exclusions from the 25% limit are:

(a) Dividends paid that are:

(i) passed through to plan beneficiaries;

(ii) used to repay principal on ESOP loans;

(iii) reinvested in employer stock.

(b) Contributions by "S" corporations to pay interest on ESOP loans;

(c) Insurance premiums on the life of the seller shareholder utilized to pay off the purchase money note in a seller-financed ESOP.

2. Monetary Limits under IRC § 415:

   (a) The lesser of $41,000 (as indexed by inflation since 2004) or 100% of covered compensation.

   (b) Covered compensation cannot exceed $205,000 (as indexed by inflation since 2004).

3. Participation:

   (a) Excluded Employees:

      (i) nonresident aliens;

      (ii) employees in a separate line of business;

      (iii) employees covered by collective bargaining agreements;

      (iv) employees related to the selling shareholder.

   (b) All employees over 21 who have completed one (1) year of service that includes 1,000 hours of service.

   (c) At least 70% of all non-highly compensated must be covered IRC § 414.

4. Minimum Vesting.

   (a) 3 year cliff, IRC § 411; or

   (b) 20% after 2 years, then 20% per year in years 3 through 6 IRC § 411.

5. Special ESOP Rules.

   (a) After an ESOP participant reaches at 55 and has participated in the Plan for 10 years, he has a right to diversify up to 25% of employer stock allocated to his account. After 6 years, he can bring the diversified portion up to 50%. IRC § 401(a)(28)(B).

   (b) Closely held company ESOP plans must provide a "put option" on company stock distributed to participants at the then current fair market value. IRC § 409(h)(1).

   (c) The Plan may provide for a right of first refusal in the event a retired employee desires to sell distributed stock.

   (d) IRC § 401(a)(28)(C) requires an independent appraiser annually.

XI. IMPLEMENTATION.

1. Feasibility Study. Data needed:

   - succession plan
   - employee census
   - financial and tax analysis

2. Valuation of the Company Stock

   - discuss rollup (See Exhibit "A")

3. Decision on "C" Corp., allowing 1042 tax deferral; or "S" Corp. removing income tax burden completely.

4. Plan Documents

5. Financing

   - inside
   - outside

6. Selection of plan trustee

   Separate counsel for:

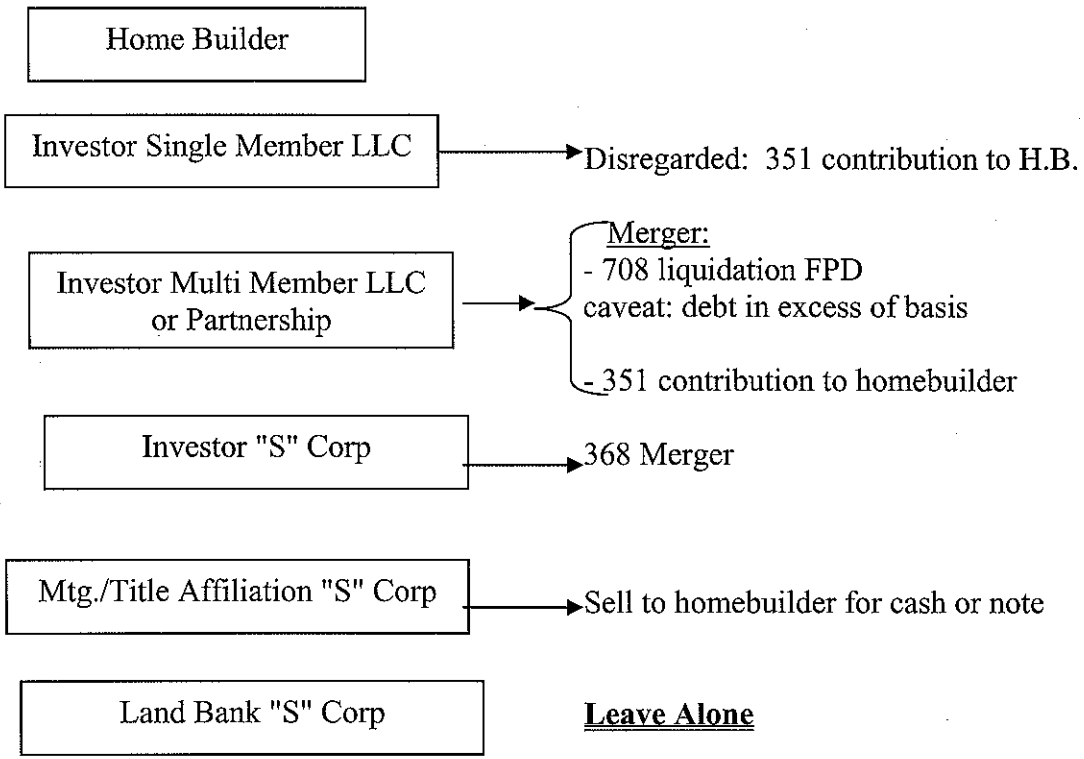
   - company
   - selling shareholder(s)
   - plan trustee
   - third party lender (if any)

Exhibit "A"

ROLLUP

Original Investor Structure

Note: 3 Same for other multi-entity organizations such as:
1. self-storage
2. restaurant chain



Caveat: Step Transaction

Note: 1. If Partnerships (LLC's) have "inventory land", then contribute 99% of partnership interest under § 351 to avoid loss of holding period.
2. If purpose of roll-up includes cash (e.g. sale or ESOP), then any one or more entity or its assets could be purchased at fair market value by the home builder.

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Exhibit "B"

LEVERAGE ESOP

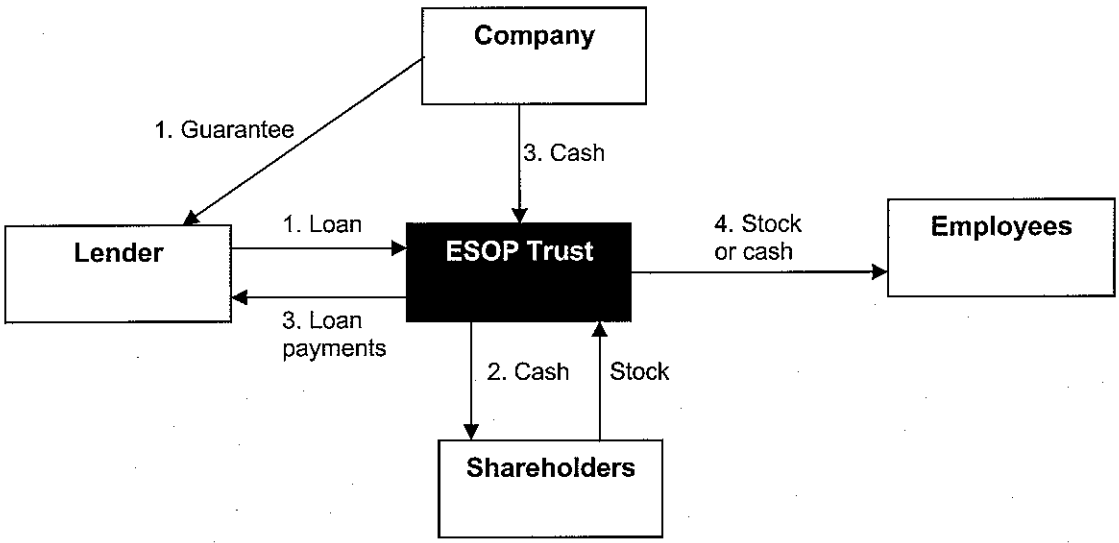
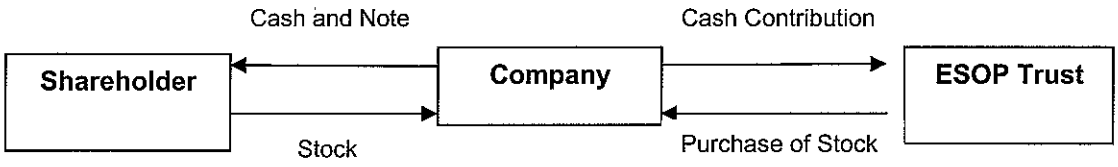


Exhibit "C"

REDEMPTION/ESOP

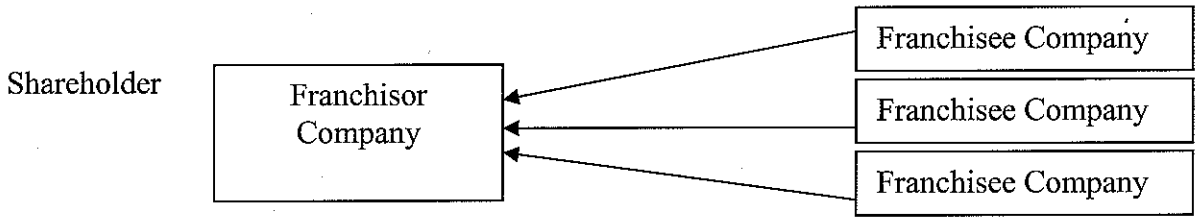


This technique is used when the amount of the employee payroll is small in comparison to EBITDA. The redemption allows the Company to pay more of its EBITDA to the selling shareholder, while capping out on the ESOP contribution of 25% of payroll. Thus, the shareholder can get paid out over a shorter period of time.

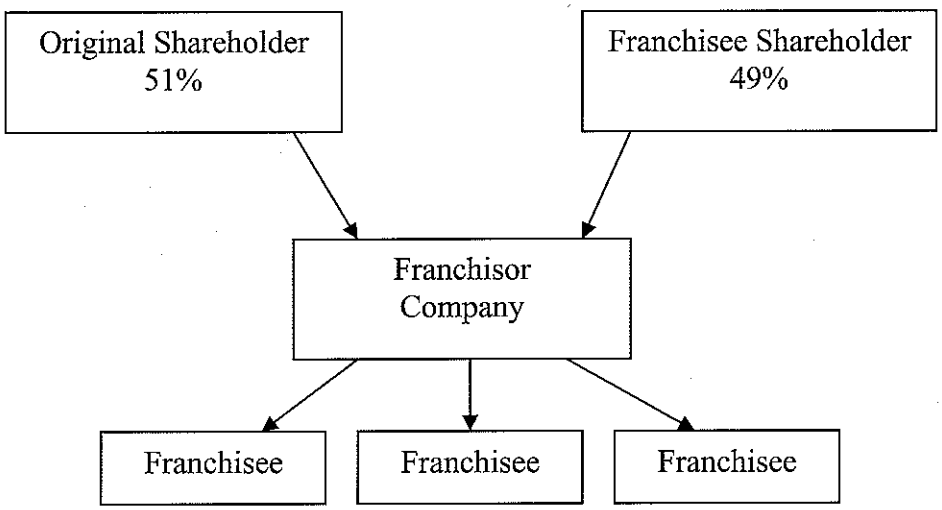
Exhibit "D"

ACQUISITION/ESOP

STEP 1: Merger of Franchisees into Franchisor in return for 49% of Franchisor.



RESULT:



STEP 2: Formation of ESOP which purchases the stock of the 51% Shareholder.

RESULT: Franchisees acquire 100% of Franchisor using tax deductible dollars.

Exhibit "E"

ESTATE PLANNING FOR ESOP NOTES

The facts are that both husband and wife received a $15 million note each, for a total of $30 million. The notes are payable in equal monthly installments of principal and interest at 7%. The effect of contributing each note to a family limited partnership. The valuation company estimates the sum of the discount of the value of the note itself and the discount on the limited partnership interest should be somewhere in the range of 70%, bring the value of direct gift to the heirs on each partnership to $4,500,000, for a total of $9M for both of them.

The attached illustration shows a gift of the limited partnership interests to a GRAT instead of directly to the children, "zeroing out" the value of the interest. Use 10 years for the life of the GRAT.

Exhibit E-1

POST DISCOUNTED VALUE WITH GRAT

Year	Note Principal Value *	Note Annual Interest	FLP Interest Value (70% Discount)	GRAT Annual Payment **	FLP Assets Year End ***	Taxable Estate ****
1	$ 13,500,000.00	$ 945,000.00	$ 4,050,000.00	$ 477,129.28	$ 13,967,870.72	
2	$ 13,500,000.00	$ 945,000.00	$ 4,190,361.22	$ 477,129.28	$ 14,435,741.44	
3	$ 13,500,000.00	$ 945,000.00	$ 4,330,722.43	$ 477,129.28	$ 14,903,612.16	
4	$ 13,500,000.00	$ 945,000.00	$ 4,471,083.65	$ 477,129.28	$ 15,371,482.88	
5	$ 13,500,000.00	$ 945,000.00	$ 4,611,444.86	$ 477,129.28	$ 15,839,353.60	
6	$ 13,500,000.00	$ 945,000.00	$ 4,751,806.08	$ 477,129.28	$ 16,307,224.32	
7	$ 13,500,000.00	$ 945,000.00	$ 4,892,167.30	$ 477,129.28	$ 16,775,095.04	
8	$ 13,500,000.00	$ 945,000.00	$ 5,032,528.51	$ 477,129.28	$ 17,242,965.76	
9	$ 13,500,000.00	$ 945,000.00	$ 5,172,889.73	$ 477,129.28	$ 17,710,836.48	
10	$ 13,500,000.00	$ 945,000.00	$ 5,313,250.94	$ 477,129.28	$ 18,178,707.20	
			$ 5,453,612.16	$ 4,771,292.80		**$ 4,771,292.80**

FLP Assets End of Term: **$18,178,707.20**
FLP Interest Post-Discount End of Term: **$5,453,612.16**
Total GRAT Payments: **$4,771,292.80**
Asset Subject to Estate Tax: **$4,771,292.80**

*Principal Value and Interest Payments are shown as 90% of Actual Note and Interest Payments since note holder retains 10% interest in the FLP.

, * Illustration assumes GRAT Payments are accumulated in the taxable estate. If these payments are spent in part or in whole, the "taxable estate" assets would be reduced.

*** Illustration assumes FLP Assets are retained in the FLP. Any distributions from or expenses incurred by the FLP would reduce assets in the FLP.

This Illustration does not include the use of lifetime or annual gifts that may not be subject to gift or estate taxes.

Exhibit "C-1"

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Current Estate / GST Tax Law

Tax Year	Tax Rates	Exemption Amount	Basis Step-Up At Death
2009	45%	$3,500,000	Currently Applies
2010 (Repealed)	None	$1,300,000	Eliminated
2011	35%	$5,000,000	Reinstated
2012	35%	$5,120,000	Reinstated
2013 & Beyond	55%*	$1,000,000	Reinstated

*5% additional surtax for transfers over $10M up to $17.184M

- **Estate & Gift Tax Exemptions and Rates may change due to pending reinstated old 2001 tax law.**

Exhibit C-2

12/2/11 - 15Q5794.pptx

Current Gift Tax Law

Tax Year	Tax Rates	Exclusion Amount	Annual Exclusion
2009	45%	$1,000,000	$13,000
2010	35%	$1,000,000	$13,000
2011	35%	$5,000,000	$13,000
2012	35%	$5,120,000	$13,000
2013 & Beyond	55%	$1,000,000	$13,000

Key Points:

- **<u>NO</u> portability of Generation Skipping Tax.**
- **Top Gift Tax / GST Rates increases <u>20%</u> from 2012 to 2013.**
- **Do plan gifts for the "Eleventh Hour of 2012" to save 20%.**

Exhibit “D”

12/2/11 - 15Q5794.pptx

WILLIAM CLINTON INTER VIVOS SPOUSAL TRUST

- The Trust is intended to receive gifts from Bill in order to utilize his increased estate and GST tax exemption.

Trust Terms

- The Trustee has discretion to distribute income and/or principal to Hillary for her health, maintenance and support and as the Independent Trustee[1] determines to be in her Best Interests.[2]
- The Trustee also has discretion to distribute income and/or principal for the health, education and maintenance of Bill's descendants and as the Independent Trustee determines to be in their Best Interests; however, Hillary is intended to be the primary beneficiary.
- Upon Hillary's death, the remaining assets of the trust will be divided into separate trusts for Bill's descendants, subject to Hillary's ability via her estate planning documents to appoint the remaining assets to anyone other than herself or her estate.

Dynasty Trusts for Descendants

- The Trustee will distribute income and/or principal for the health, education, maintenance and support of the beneficiary and his or her descendants.
- The Trustee will distribute income and/or principal as the Independent Trustee determines for the "Best Interests" of the beneficiary and his or her descendants.
- When the beneficiary dies, assets will be divided into equal Dynasty Trusts for the beneficiary's descendants or if the beneficiary has no descendants, will be added to the trust for his or her siblings, subject to the beneficiary's ability to appoint the assets amongst Bill's descendants.
- The Dynasty Trusts will continue for the maximum period permitted by Florida law.

[1] An Independent Trustee is a Trustee who is not related or subordinate to any beneficiary.

[2] The "Best Interests" standard provides the Trustee broad discretion to contemplate not only distributions as necessary for the support, education, welfare, emergency, safety needs, medical care and comfort of the beneficiary, but also distributions to permit the beneficiary: to purchase a personal residence; to pay reasonable wedding expenses; to purchase, initiate or invest in a business which the Trustee personally deems to be sound or promising; etc.

Exhibit E-1

12/2/11 – 15Q5794.pptx

Historically Low Interest Rates: Planning Opportunity!

Lump Sum Loan (Nine Year Term) to Fully Fund "10 Pay" $ 5M Life Insurance Policy

Date of Loan	Mid-Term AFR	Amount Shifted to Right Pocket
Oct-11	1.19%	$ 3,400,000
Jul-11	2.00%	$ 4,400,000
Oct-06	4.82%	$ 23,100,000
Oct-01	4.59%	$ 16,250,000
Oct-98	5.12%	$ 52,600,000
Average Since 1998	4.06%	$ 9,800,000

Exhibit E-2

12/2/11 - 15Q5794.pptx

Exhibit F-1 **Hypothetical Summary of Private Financing Transaction: 9 Year Mid-Term Note**

12/2/11 - 15Q5794.pptx

Year	Age	Loan Amount	Loan Interest (at Mid-Term AFR Rate of 1.19%)*	Loan Interest Paid	Cummulative Loan EOY	Gifts to Trust	Gift Taxes Paid by Grantor	BOY ILIT Balance	Cashflow for Premium (BOY)	Withdrawl for Note*	ILIT Growth (at 5.35%)	EOY ILIT Balance	Life Insurance Death Benefit (DB)	Value to Heirs
1	68	3,400,000	40,460	0	3,440,460	0	0	3,400,000	(128,000)	0	175,052	3,447,052	5,000,000	5,006,592
2	69	0	40,941	0	3,481,401	0	0	3,447,052	(128,000)	0	177,569	3,496,621	5,000,000	5,015,220
3	70	0	41,429	0	3,522,830	0	0	3,496,621	(128,000)	0	180,221	3,548,643	5,000,000	5,026,012
4	71	0	41,922	0	3,564,752	0	0	3,548,843	(128,000)	0	183,015	3,603,858	5,000,000	5,039,106
5	72	0	42,421	0	3,607,172	0	0	3,603,858	(128,000)	0	185,958	3,661,818	5,000,000	5,054,644
6	73	0	42,925	0	3,650,098	0	0	3,661,816	(128,000)	0	189,059	3,722,875	5,000,000	5,072,777
7	74	0	43,438	0	3,693,534	0	0	3,722,875	(128,000)	0	192,326	3,787,201	5,000,000	5,093,667
8	75	0	43,953	0	3,737,487	0	0	3,787,201	(128,000)	0	195,767	3,854,968	5,000,000	5,117,481
9	76	0	44,476	0	3,781,963	0	0	3,854,968	(128,000)	0	199,393	3,926,361	5,000,000	5,144,398
10	77	(3,781,963) (End of Year 9)	0	0	0	0	0	3,926,361	(128,000)	(3,781,963)	877	17,275	5,000,000	5,017,275
11	78	0	0	0	0	0	0	17,275	0	0	924	18,199	5,000,000	5,018,199
12	79	0	0	0	0	0	0	18,199	0	0	974	19,173	5,000,000	5,019,173
13	80	0	0	0	0	0	0	19,173	0	0	1,026	20,199	5,000,000	5,020,199
14	81	0	0	0	0	0	0	20,199	0	0	1,081	21,280	5,000,000	5,021,280
15	82	0	0	0	0	0	0	21,280	0	0	1,138	22,418	5,000,000	5,022,418
16	83	0	0	0	0	0	0	22,418	0	0	1,199	23,617	5,000,000	5,023,617
17	84	0	0	0	0	0	0	23,617	0	0	1,264	24,881	5,000,000	5,024,881
18	85	0	0	0	0	0	0	24,881	0	0	1,331	26,212	5,000,000	5,026,212
19	86	0	0	0	0	0	0	26,212	0	0	1,402	27,614	5,000,000	5,027,614
20	87	0	0	0	0	0	0	27,614	0	0	1,477	29,092	5,000,000	5,029,092
21	88	0	0	0	0	0	0	29,092	0	0	1,556	30,648	5,000,000	5,030,648
22	89 (LE)	0	0	0	0	0	0	30,648	0	0	1,640	32,288	5,000,000	5,032,288
23	90	0	0	0	0	0	0	32,288	0	0	1,727	34,015	5,000,000	5,034,015
24	91	0	0	0	0	0	0	34,015	0	0	1,820	35,835	5,000,000	5,035,835
25	92	0	0	0	0	0	0	35,835	0	0	1,917	37,752	5,000,000	5,037,752
26	93	0	0	0	0	0	0	37,752	0	0	2,020	39,772	5,000,000	5,039,772
27	94	0	0	0	0	0	0	39,772	0	0	2,126	41,900	5,000,000	5,041,900
28	95	0	0	0	0	0	0	41,900	0	0	2,242	44,141	5,000,000	5,044,141
29	96	0	0	0	0	0	0	44,141	0	0	2,362	46,503	5,000,000	5,046,503
30	97	0	0	0	0	0	0	46,503	0	0	2,468	48,991	5,000,000	5,048,991
31	98	0	0	0	0	0	0	48,991	0	0	2,621	51,612	5,000,000	5,051,612
32	99	0	0	0	0	0	0	51,612	0	0	2,761	54,373	5,000,000	5,054,373
33	100	0	0	0	0	0	0	54,373	0	0	2,909	57,282	5,000,000	5,057,282
34	101	0	0	0	0	0	0	57,282	0	0	3,065	60,347	5,000,000	5,060,347
35	102	0	0	0	0	0	0	60,347	0	0	3,229	63,575	5,000,000	5,063,575
36	103	0	0	0	0	0	0	63,575	0	0	3,401	66,976	5,000,000	5,066,976
37	104	0	0	0	0	0	0	66,976	0	0	3,583	70,560	5,000,000	5,070,560
38	105	0	0	0	0	0	0	70,560	0	0	3,775	74,335	5,000,000	5,074,335
39	106	0	0	0	0	0	0	74,335	0	0	3,977	76,312	5,000,000	5,078,312
40	107	0	0	0	0	0	0	78,312	0	0	4,190	82,501	5,000,000	5,082,501
41	108	0	0	0	0	0	0	82,501	0	0	4,414	86,915	5,000,000	5,086,915
42	109	0	0	0	0	0	0	86,915	0	0	4,650	91,565	5,000,000	5,091,565
43	110	0	0	0	0	0	0	91,565	0	0	4,899	96,464	5,000,000	5,096,464
44	111	0	0	0	0	0	0	96,464	0	0	5,161	101,625	5,000,000	5,101,625
45	112	0	0	0	0	0	0	101,625	0	0	5,437	107,061	5,000,000	5,107,061
46	113	0	0	0	0	0	0	107,061	0	0	5,728	112,789	5,000,000	5,112,789
47	114	0	0	0	0	0	0	112,769	0	0	6,034	118,824	5,000,000	5,118,824
48	115	0	0	0	0	0	0	118,824	0	0	6,357	125,181	5,000,000	5,125,181
49	116	0	0	0	0	0	0	125,161	0	0	6,697	131,878	5,000,000	5,131,878
50	117	0	0	0	0	0	0	131,878	0	0	7,055	138,933	5,000,000	5,138,933

*Loan repayment is made at the end of year 9; it is summarized as year 10 in the chart for illustrative purposes. Hypothetical example for illustrative purposes only. Individual results may vary.

Exhibit F-2

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MyLifeAudit.com

Year	BOY Loan Balance	Interest Accrued	EOY Loan Balance	BOY Investment Balance	Policy Premiums	Investment Earnings	EOY Loan Repayment	EOY Investment Balance	Trust Owned Death Benefit	Trust Value @ Death Net of Loan
1	5,000,000	60,000	5,060,000	5,000,000	(189,152)	240,542	-	5,051,390	10,000,000	9,991,390
2	5,060,000	60,720	5,120,720	5,051,390	(189,152)	243,112	-	5,105,350	10,000,000	9,984,630
3	5,120,720	61,449	5,182,169	5,105,350	(189,152)	245,810	-	5,162,008	10,000,000	9,979,840
4	5,182,169	62,186	5,244,355	5,162,008	(189,152)	248,643	-	5,221,499	10,000,000	9,977,144
5	5,244,355	62,932	5,307,287	5,221,499	(189,152)	251,617	-	5,283,964	10,000,000	9,976,677
6	5,307,287	63,687	5,370,974	5,283,964	(189,152)	254,741	-	5,349,553	10,000,000	9,978,379
7	5,370,974	64,452	5,435,426	5,349,553	(189,152)	258,020	-	5,418,421	10,000,000	9,982,995
8	5,435,426	65,225	5,500,651	5,418,421	(189,152)	261,463	-	5,490,733	10,000,000	9,990,081
9	5,500,651	66,008	5,566,659	5,490,733	(189,152)	265,079	(5,566,659)	1	10,000,000	10,000,001
10	-	-	-	1	-	0	-	1	10,000,000	10,000,001
11	-	-	-	1	-	0	-	1	10,000,000	10,000,001
12	-	-	-	1	-	0	-	1	10,000,000	10,000,001
13	-	-	-	1	-	0	-	1	10,000,000	10,000,001
14	-	-	-	1	-	0	-	1	10,000,000	10,000,001
15	-	-	-	1	-	0	-	1	10,000,000	10,000,001
16	-	-	-	1	-	0	-	1	10,000,000	10,000,001
17	-	-	-	1	-	0	-	1	10,000,000	10,000,001
18	-	-	-	1	-	0	-	1	10,000,000	10,000,001
19	-	-	-	1	-	0	-	1	10,000,000	10,000,001
20	-	-	-	1	-	0	-	1	10,000,000	10,000,001
21	-	-	-	1	-	0	-	1	10,000,000	10,000,001
22	-	-	-	1	-	0	-	1	10,000,000	10,000,001
23	-	-	-	1	-	0	-	1	10,000,000	10,000,001
24	-	-	-	1	-	0	-	1	10,000,000	10,000,001
25	-	-	-	1	-	0	-	1	10,000,000	10,000,001
26	-	-	-	1	-	0	-	1	10,000,000	10,000,001
27	-	-	-	1	-	0	-	1	10,000,000	10,000,001
28	-	-	-	1	-	0	-	1	10,000,000	10,000,001
29	-	-	-	1	-	0	-	2	10,000,000	10,000,002
30	-	-	-	2	-	0	-	2	10,000,000	10,000,002
31	-	-	-	2	-	0	-	2	10,000,000	10,000,002
32	-	-	-	2	-	0	-	2	10,000,000	10,000,002
33	-	-	-	2	-	0	-	2	10,000,000	10,000,002

Actual Contribution	5,000,000
Starting Balance	-
Growth Rate	5.00%
Loan Rate	1.20%
Loan Years	9
Debt to Equity	100%
Target Year	9

Exhibit G-1

12/2/11 - 15Q5794.pptx

Charitable Gift Annuity Alternative

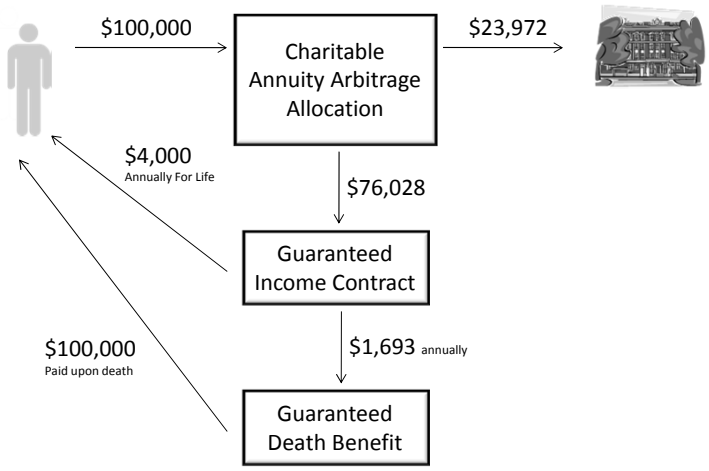
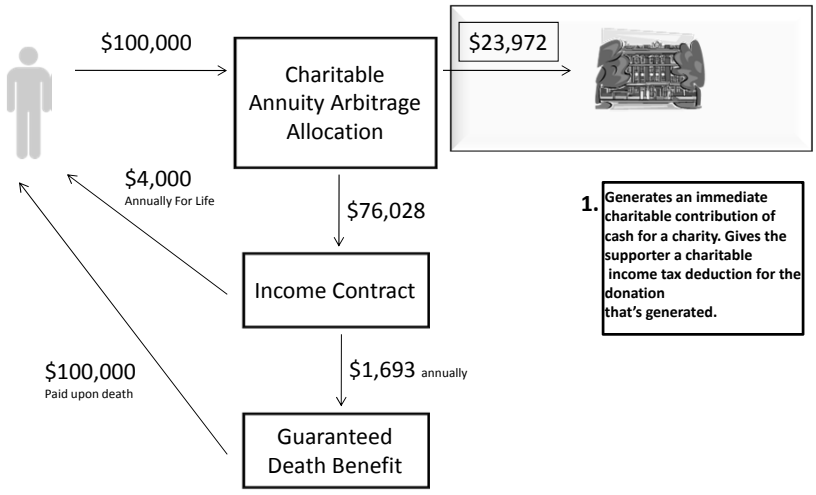


Exhibit G-2
12/2/11 - 15Q5794.pptx

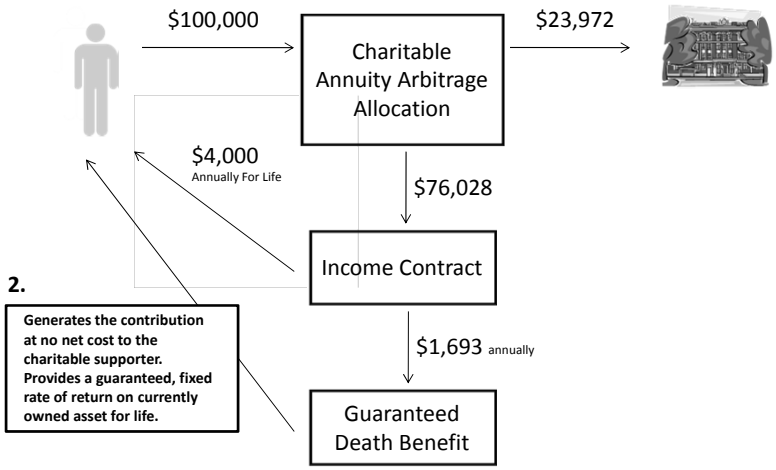
1. Win For Nonprofit



1. **Generates an immediate charitable contribution of cash for a charity. Gives the supporter a charitable income tax deduction for the donation that's generated.**

Exhibit G-3
12/2/11 - 15Q5794.pptx

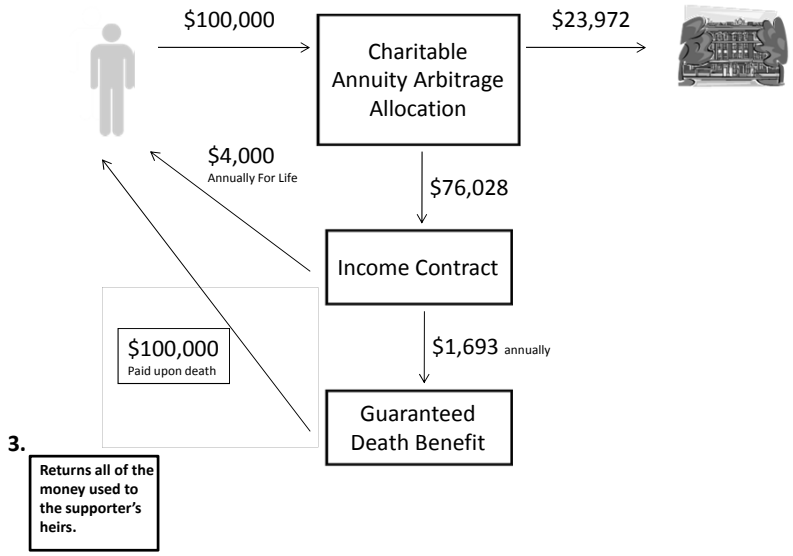
2. Win For Supporter



2. **Generates the contribution at no net cost to the charitable supporter. Provides a guaranteed, fixed rate of return on currently owned asset for life.**

Exhibit G-4
12/2/11 - 15Q5794.pptx

3. Win For Family/Heirs



3. **Returns all of the money used to the supporter's heirs.**

Exhibit G-5
12/2/11 - 15Q5794.pptx

Charitable Annuity Arbitrage

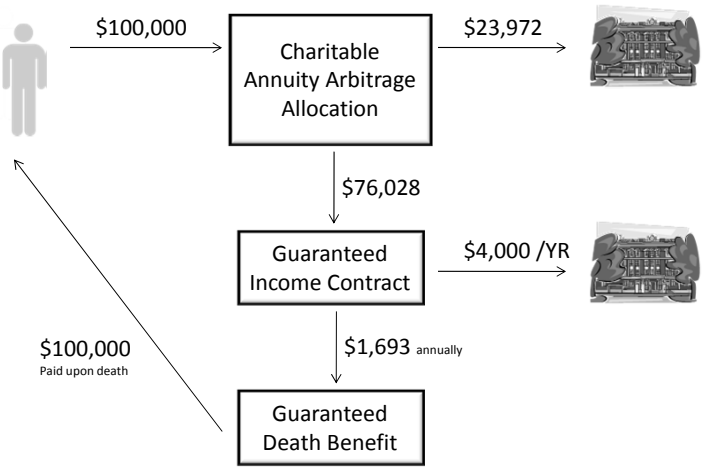


EXHIBIT "H"

CAPTIVE INSURANCE COMPANIES

PRESENTED AT THE FICPA

2011 ESTATE AND FINANCIAL PLANNING CONFERENCE

DECEMBER 2, 2011

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I. THE CAPTIVE INSURANCE COMPANY

A captive insurance company is an insurance company formed by a business owner to insure the risks of an operating business. The operating business pays premiums to the captive, and the captive insures the risks of the operating business. It must be operated as a real insurance company with reserves, surplus, insurance policies, policyholders and claims. It must be licensed as an insurance company in the venue where it is formed. The insurance policies and the risks covered thereunder must be based on professionally tested insurance experts to provide the same business risk/profit used by all insurance companies. There must be a clear insurable risk for each policy.

While the main focus of this outline will be on the tax benefits, both income and estate, of the captive, the captive provides the means by which a business owner can increase profitability by creating a profit inside the captive and reducing insurance costs in the operating company. The profitability at the insurance company level is higher for companies who have lower claim experience. This lower claim experience can also reduce the costs of insurance at the operating company level by increasing the amount of deductibles or coverages on many insurance policies already in existence at the operating company. The captive then invests the premiums at a profit, and by not having to pay out as many claims as the average insured (the basis upon which the premiums are calculated), additional profits are achieved by both companies.

In addition to these increased revenues, the administrative cost of running a captive is substantial lower than the administrative portion of the premiums charged by insurance companies, including agents commissions, advertising and costs of compliance, and administrative costs which is often based on salaries.

The existence of a captive is also useful in negotiating commercial insurance rates.

The typical insurance company analysis performed by all insurance companies is based on average claimed rates. If your client knows that its claim rate is low, then he also knows that his premium is probably more profitable to the insurance company than most insureds. This give the captive a strategy and opportunity to make more money on the premiums than the average insurance company. Not only are its expenses lower, the captive will not have other non-insurance investments such as real estate, mortgages, etc., the risk of not making a profit is much smaller.

Some other benefits include:

- increased claims control;
- access to reinsurance markets which is usually only available to a licensed insurance company; and
- better policy terms.

Contrary to popular belief, captives are not just for big public companies (most of which own captives). Because of increased use and clear tax understanding, these entities are being set up for smaller companies and professionals who wish to accomplish the above-described goals.

For the smaller groups, the cost of setting the captive up and maintaining it are not nearly as expensive as you might think.

II. INCOME TAX TREATMENT

A. DEFINITIONS

IRC §816(a)(2) defines "insurance company" as "any company more than half of the business of which during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Originally, the IRS challenged captives on a theory known as the "Economic Family". But the service lost these cases continuously, ending with its last effort in *United Parcel Service v. C.I.R.*, 254 F.3d 1014 (11th Cir. 2001). After giving up on its "Economic Family" argument, the IRS began to concentrate on the definition of "Insurance", which was defined by the U.S. Supreme Court when it held that "Historically and commonly, insurance involves risk shifting and risk-distribution." *Helvering v. LeGiuse*, 312 U.S. 531, 615 Ct. 646 (1941).

1. Risk Shifting

Risk shifting occurs when risk is transferred to an insurer in return for the payment of premiums. The insureds can be related, however, there is no insurance when a subsidiary insures its parent. *Stearns-Rogers Corporation v. U.S.*, 774 F.2d 414 (1985); *Beech Aircraft Corp. v. U.S.*, 797 F.2d 920 (1986); *Gulf Oil Corporation v. U.S.*, 89 T.C. No. 70 (1987).

2. Risk Distribution

The primary IRS challenge is now on "risk distribution". Risk distribution is the method of reducing the danger of potential loss by spreading costs throughout a group. *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950). In other words, is the captive issuing a sufficient number of policies to different insureds? Risk is spread over some undefined number of claims and exists so long as one of the two following safe harbors is met:

a. At least 50% of the risks underwritten are for unaffiliated third-parties. Rev. Rule 2002-89 2002-2 C.B. 984 and 2002-90, 2002-2 C.B. 985. This can be accomplished by finding quality reinsurance risk to underwrite. Reinsurance typically set up amongst several captives by the captive insurance consultant.

b. Underwriting 11 or more separate insureds, even if they are affiliated with the captive (disregarded entities do not count). Rev. Rule 2005-40, 2005-2 C.B. 4.

3. Protected Cell Captive

A protected cell is a captive insurance company formed by a "sponsor". This protected cell company typically establishes multiple accounts, or "cells", each of which has its own name and is identified with a specific participant. Usually, the sponsor owns all of the

common stock of the captive, with all the non-voting preferred stock owned by cell participants. Each participant has its own separate preferred stock and is funded by each separate participant. All the premiums collected with regard to each recipient are defined to their specific cell, out of which their specific expenses are accumulated and offset. Income earned within the cell is paid out on an individual basis to each participant as dividends on his preferred stock. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of the protected cell company. In the event a participant ceases to participate, the participant is entitled to receive a return of its assets within its cell.

4. Miscellaneous

A captive can be every type insurance company other than a life insurance company. IRC §831(a). A life insurance company is defined under IRC §816.

B. IRS REQUIREMENTS

1. In addition to fitting with the definition of an insurance company, all captives must meet the following criteria in order to be taxed as an insurance company:

a. The captive is regulated as an insurance company in whatever venue it does business;

b. An adequate amount of capital is present within the insurance company;

c. The insurance company is able to pay claims;

d. The insurance company's financial performance is adequate;

e. The captive's business operations and assets are kept separate from the business operations and assets of its shareholders; and

f. The captive maintains separate financial reporting from the parent and any affiliated companies.

2. In addition, the captive must also operate like an insurance company, including:

a. The insured parties truly face hazards;

b. Premiums charged by the captive are based on commercial rates;

c. The risks are shifted and distributed to the insurance company, since the entities are commercially and economically related;

d. The policies contain provisions such that the covered risks may exceed the amount of premiums charged and paid;

e. The validity of claims are established before payments are made;

f. The premiums of the operating subsidiaries were determined at arms-length;

g. The premiums were pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others; and

h. The captive and its insureds conducted themselves in all respects as unrelated parties would in a traditional relationship.

C. INCOME TAXATION

1. If the captive qualifies as an insurance company under IRC §831(a), so long as the net premiums for the taxable year are greater than $350,000 but do not exceed $1,200,000 and the permanent election required by IRC §831(b)(2)(ii) is made, the captive will be subject to corporate income tax only on its investment income. IRC §831(b). Thus, a captive does not pay income tax on ordinary income up to $1,200,000.

2. IRC §834 states that taxable investment income is gross investment income from:

(i) interest;
(ii) rents;
(iii) royalties;
(iv) gains from the sale of exchange of capital assets; and
(v) income from partnership.

LESS deductions including:

(i) tax-free interest under IRC §103;
(ii) investment expenses;
(iii) real estate expenses;
(iv) depreciation;
(v) interest paid or accrued;
(vi) capital losses;
(vii) dividend received deductions;
(viii) trade or business expenses other than those attributable to the insurance business; and
(ix) depletion.

3. The payment of reasonable premiums by an ongoing business to a captive insurance company are deductible for federal income tax purposes. IRC §832(b). If not

reasonable, the entire deduction may be challenged by the IRS. If the IRS prevails and the deduction is disallowed, back taxes, interest and penalties may be assessed. If it can be shown that otherwise deductible insurance premiums were for coverage that was intended to be excessive, the courts have exercised their discretion to disallow all or part of that deduction. See Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd., 299 F.3d 221 (3d Cir. 2002). Accordingly, each participating Member's premiums should not be increased in a manner designed to achieve a refund of unused reserves at the end of the policy.

4. The entity must be a regular C corporation, not an "S" corp or partnership for tax purposes. See §1361(b)(2)(R) prohibiting insurance companies from electing "S" corp status.

5. "Controlled Groups" are defined under IRC §1503(a) - except that "more than 50%" shall be substituted for "at least 80%" - shall be treated as one for purposes of calculating the premium limits set forth in IRC §831(b)(2)(A).

6. Foreign domiciled insurance companies are subject to reporting requirements, the passive foreign investment company tax under IRC §1297, federal excise tax on premiums paid under IRC §4371. Foreign Captives usually make an election under IRC §953(d) to be taxed as a U.S. domiciling entity to avoid these problems.

III. ESTATE PLANNING

A. WEALTH TRANSFER

In addition to the business and income tax benefits described hereinabove, the payment of premiums by the operating company to the captive effectively transfers cash from the operating business into the captive. To the extent that the captive is owned by junior family members, a wealth shift has taken place. Moreover, because the premiums are deductible to the operating company and the first $1.2 million of premium payments to the captive are not subject to federal income tax, the operating company is in effect transferring pretax income into a vehicle that will not pay tax on such premiums and likely be shielded from the creditors of the owners of the operating company. This strategy can be accomplished by organizing the captive in a favorable asset protection venue and having the stock of the captive be owned (i) directly by the junior family members of the operating company shareholders, (ii) by a family limited liability limited partnership ("FLLLP"), or limited liability company ("LLC"), or (iii) by a trust for the benefit of the junior family members. This strategy should not trigger any adverse transfer tax consequences if the entity is owned by junior family member from creation without any fraudulent conveyance issues. Thus, up to $1.2 million of income tax can be transferred out of the business owner's estate every year without utilizing either annual gift exemptions or by a lifetime gift exemption. Such pre-tax premium income would, of course, be subject to the insurance risks applicable to the captive.

This type of family planning is commonly referred to as a closely-held insurance company ("CHIC"). There are a variety of ways to provide for the business owner's children:

1. The CHIC can be structured with the parents owning voting shares and the children owning nonvoting common or preferred stock. This keeps the parents in control but the majority of the value of the CHIC out of their estate. To the extent desired, preferred dividends, salaries or other compensation could be retained by the parents.

2. The children's share of the CHIC could be owned by a trust for their benefits. The benefits of this structure are:

a. The value of the CHIC is kept out of the parents' estate;

b. The value can be protected against the creditors of the operating company, the parents and the children (including future creditors, predators and ex-spouses);

c. A Generation Skipping Tax ("GST") dynasty trust would avoid estate tax for junior family members and their lineal descendants; and,

d. Taxation of the CHIC income may under certain circumstances be borne by the beneficiaries, which may be useful if they are in a lower bracket than the parents. Alternatively, the income tax burden can be borne by the parents of the trust beneficiaries to the extent a defective grantor trust created by the parent is the owner of the shares.

3. The stock of the CHIC could also be owned by an LLLP or an LLC which provides "charging order" protection to their equity interest holders. Caveat re current "Chinks" in the Armor of the LLC charging order.

B. ASSET PROTECTION

1. Rather than issuing the stock of the captive directly to the shareholder of the operating company (or to a holding company), for better asset protection, their stock could be issued to an offshore trust. Utilization of an Alaska, Wyoming, or Delaware asset protection trust also provides asset protection benefits; albeit, not as good as foreign asset protection trusts. Moreover, the registration and maintenance costs in the United States may not be as appealing as in offshore countries. In countries such as Nevis, the trust which owns the company’s shares should not be susceptible to piercing by creditors of the operating company or its shareholders, or the creditors of the children or their heirs. The states referenced above have not yet been proven in court to be as effective against creditors.

2. If the shareholder does not want to go to the expense of locating and operating an offshore company, a limited liability company ("LLC") or, better yet, a limited liability limited partnership ("LLLP") can be used to hold the captive stock. As long as it is a multi-membered entity located within a state that has sole "charging order" protection, the asset protection needs may be enough. However, the insurance requirements, the capital requirements and administrative costs of such state should be analyzed to confirm it really is cheaper. Some examples are Vermont, Arizona, Kentucky, Montana, Delaware, Maine, Nevada and Florida (with respect to LLLPs only). Vermont has been offering Captives on a reasonable basis for a

long time. Delaware has recently revised its statute to make it a more alluring venue for Captives.

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EXHIBIT "H-1"

Why Form A Captive Insurance Co.?
(Example Pro Forma)

Captive Consulting

DESCRIPTION	2010	2011	2012	2013	2014
PREMIUM INCOME	$ 600,000.00	$ 600,000.00	$ 600,000.00	$ 600,000.00	$ 600,000.00
ANNUAL OPERATING EXPENSE FOR INSURANCE					
REINSURANCE	$ 240,000.00	$ 240,000.00	$ 240,000.00	$ 240,000.00	$ 240,000.00
INSURANCE POLICY FEE	42,000.00	42,000.00	42,000.00	42,000.00	42,000.00
LETTER OF CREDIT AS CAPITAL BANK CHARGE	1,500.00	1,500.00	1,500.00	1,500.00	1,500.00
ANNUAL OPERATING EXPENSE FOR MANAGEMENT					
ADMINISTRATION AND CLAIMS PROCESSING	42,000.00	42,000.00	42,000.00	42,000.00	42,000.00
LEGAL RETAINER	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00
ANNUAL GOV'T OFFSHORE CAPTIVE EXSPENSES					
REGISTERED AGENT AND OFFICE FEE	8,000.00			8,000.00	8,000.00
REGISTRY FILING AND INSURANCE FEE	1,75				1,750.00
ONE TIME INITIAL INCORPORATION COST					
INCORPORATION FEE					0.00
LICENSE APPLICATION FEE	5				0.00
TOTAL OPERATING EXPENSES	$ 367,250.00	$		365,250.00	$ 365,250.00
NET INCOME FROM INSURANCE OPERATIONS	$ 232,750.00	$ 234,750.00	$ 2	$ 234,750.00	$ 234,750.00
INVESTMENT INCOME(SEE ANALYSIS BELOW))	13,965.00	28,887.90	44,	61,473.54	79,246.96
NET INCOME	$ 246,715.00	$ 263,637.90	$ 279,456	296,223.54	$ 313,996.96
CALCULATION OF EARNINGS ON INVESTMENTS:					
NET INCOME FROM INSURANCE OPERATIONS	$ 232,750.00	$ 234,750.00	$ 234,750.00	$ 34,750.00	$ 234,750.00
FUND RESERVES RELATING TO CLAIMS REPORTED BUT NOT PAID AND INCURRED BUT NOT REPORTED	0.00	0.00	0.00	0.00	0.00
CAPITAL STOCK AND RETAINED EARNINGS AT BEGINNING OF YEAR	0.00	246,715.00	510,352.90	789, .07	1,086,032.62
SUBTOTAL	232,750.00	481,465.00	745,102.90	1,024,559.	1,320,782.62
INVESTMENT INCOME AT ESTIMATED 6% RATE	13,965.00	28,887.90	44,706.17	61,473.54	79,246.96
TOTAL AVAILABLE CASH AND INVESTMENTS	$ 246,715.00	$ 510,352.90	$ 789,809.07	$ 1,086,032.62	$ 1,400,029.58

$ 1,400,029.58

RICHARD B. COMITER
ATTORNEY AT LAW
BIOGRAPHICAL INFORMATION

Richard B. Comiter is the senior partner of Comiter, Singer, Baseman & Braun, LLP, a Florida regional tax law firm. The focus of Mr. Comiter's practice is federal income and estate tax planning, partnership and limited liability company state law, structuring of business transactions for pass-through entities, succession and wealth transfer planning, probate, asset protection and non-qualified executive compensation. Mr. Comiter was awarded a B.S.B.A. with Honors from the University of Florida and earned a M.S.M. in Tax Accounting from Florida International University. Mr. Comiter received his Juris Doctor, with Honors, and a Master of Laws in Taxation from the Fredric G. Levin College of Law at the University of Florida. He is a member of the Board of Trustees of the Levin College of Law and is Chairman of its Planned Giving Task Force.

Mr. Comiter has been acknowledged as a leader in the field of taxation and estate planning by his peers as well as by leading legal publications. He was recently selected as the 2010-2011 Recipient of the Tax Section of The Florida Bar Gerald T. Hart Outstanding Tax Attorney of the Year Award. He has been recognized in the field of corporate tax by *Who's Who Legal*, as a member of the Florida Legal Elite by *Florida Trend*, as a Top Lawyer in Tax and Estate Planning by the *South Florida Legal Guide*, as a Top 100 Florida Super Lawyer, *The Best Lawyers in America*, and as a Leading Lawyer for Business in *Chambers USA*. He is a Fellow of The American College of Trust and Estate Counsel and is currently serving on its Asset Protection and Business Planning Committees. He is also a member of Florida Blue Key.

He is a Past-Chair of the Tax Section of The Florida Bar (the "Tax Section"). He has also served as the Director of the Education Division and Federal Tax Divisions of the Tax Section, and is a former Chair of its Individual and Pass-Through Entities, Finance, and Long Range Planning Committees. He is currently a member of the Steering and Drafting Committee which is in the process of revising Florida's Limited Liability Company Act. Mr. Comiter was formerly a member of the Limited Partnership Act Review Committee, and the Steering and Drafting Committee for the revisions to Florida's Limited Liability Company Act and the Florida Revised Uniform Partnership Act. Mr. Comiter annually lectures on Pass-Through Entities and Entity Selection at The Florida Bar's Tax Certification and Review Conference and the FICPA's Florida Institute on Federal Taxation Conference. Mr. Comiter was a columnist on S Corporations and Partnership State Law and a member of the Board of Advisors and Contributing Editors for the Journal of Partnership Taxation. Mr. Comiter is also a Florida Bar Board Certified Tax Lawyer and a Florida Certified Public Accountant.

Mr. Comiter has previously served as President of the Palm Beach/Martin County Estate Planning Council and the Palm Beach County Tax Institute. He is a Past-President of the Jewish Community Center of the Greater Palm Beaches, a member of the Board of Directors of the Jewish Federation of Palm Beach County and a Past-Chair of its Professional Advisory Committee. Mr. Comiter previously served as the Regional Vice-President and member of the Board of Directors of the Florida Association of Attorney-Certified Public Accountants.

Mr. Comiter has lectured in programs sponsored by the American Bar Association, The Florida Bar, the Florida Institute of Certified Public Accountants, The American College of Trust and Estate Counsel, the Lawyers Guaranty Fund Assembly, New York University's Institutes on Partnership Taxation and Closely Held Businesses, the National Business Institute and the Graduate Tax Department at the Levin College of Law at the University of Florida. Mr. Comiter has been a guest speaker for numerous other Florida professional, educational, income and estate planning councils and business organizations.

Domenick R. Lioce, Esq., CPA

Shareholder

Nason, Yeager, Gerson, White & Lioce, P.A.

Domenick R. Lioce, born in Paterson, New Jersey, February 13,1951; admitted to the bar 1979, Florida; U.S. District Court, U.S. Tax Court, U.S. Court of Appeals, 11th Circuit. Undergraduate, graduate and legal education at Florida State University (B.S., 1973; M.A., 1978; J.D., 1979). Mr. Lioce has been a Certified Public Accountant in Florida since 1976. Member: Florida Institute of Certified Public Accountants; Florida Bar Association: Member of the Tax Section, Chairman and Member of the Tax Section Board of Directors, Member of the Executive Council, and Chairman of the Tax Sponsors Committee and Chairman of the Long-Range Planning Committee; also Member and Vice Chairman of The Business Law Section Bar/FICPA Liaison Committee; Member of the Drafting Committee of the New Florida Revised Limited Liability Company Act; Former Member of the Drafting Committee of The Florida Revised Limited Partnership Act and the Florida Revised Partnership Act; American Association of Attorney-CPA's: President of the Florida Chapter, Member of the National Board of Directors and Executive Committee, Treasurer; Member of the National Continuing Education Committee and the Meetings Committee and Chairman of the National Sponsors Committee; Director and Past President of Palm Beach Tax Institute; Member and past Board Member of Florida State Alumni Association; past Chairman and Director of Forum Club of the Palm Beaches. Mr. Lioce is rated AV (the highest rating possible) by the Martindale-Hubbell Law Directory.

Author: "Partnership of P.A.'s" (1980); "The New Incentive Stock Option Created under the Economic Recovery Act of 1982;" "Dealer vs. Investor Status" (1985); "The 1986 Tax Reform Act" (1986); "Contesting Commercial Property Assessments" published in the Palm Beach Post and the South Florida Business Journal, 1991; "Don't be a "C" if you can help it". Co-author, "Partnership Law Update" published in Fall 1994; "Partnership Law Update" (1995); "The Florida Revised Uniform Partnership Act" (1995); "Disregarded Entities" (2001); "New Tax Rules Remove Roadblock to Limiting Liability" (2001); "It's Time to Convert!" (from C Corporation to S Corporation) (2002); "Unreasonable Low Compensations: The Story of the Three Little Pigs" (2003); "Choice of Entity" Florida Bar Tax Certification Exam Outline, updated February, 2010. The Florida Bar Journal: "Chinks in the Armour: Current Trends in Limited Liability Companies After Olmstead" (January 2011).