Family Office Exchange®

July 22-23, 2014
Chicago, IL

FOX Financial Executives Forum

CRITICAL UPDATES FOR FAMILY OFFICE OPERATIONS

2014 Financial Executives Forum

Agenda

Tuesday, July 22

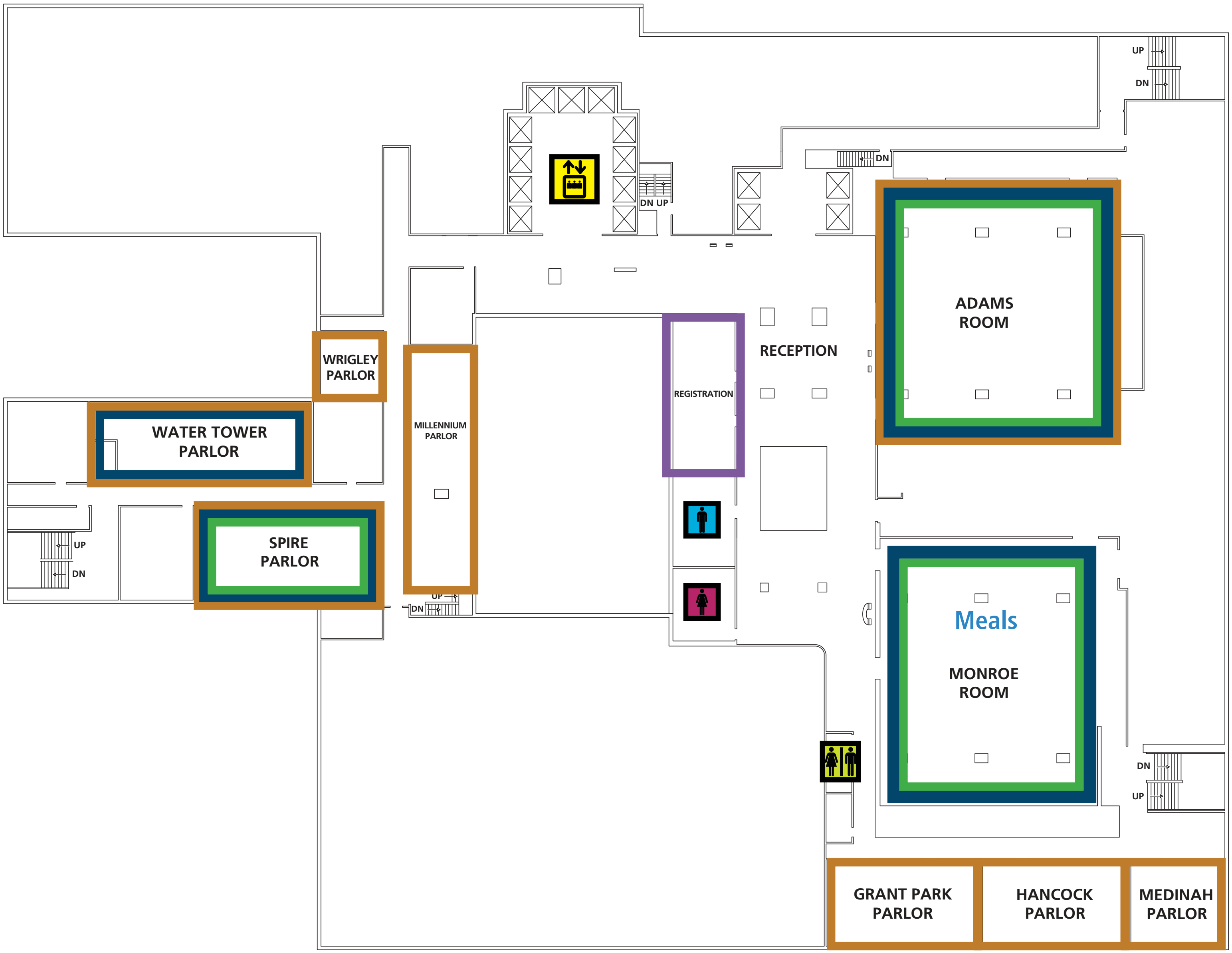
REGISTRATION	**11:30 a.m.**	**6th floor Foyer**
LUNCH	**12:00 p.m.**	**Monroe**
WELCOME/FOX INITIATIVES FOR 2014	**1:00 p.m.**	**Adams**
DON'T START AT SQUARE ONE – IMPLEMENTING TECHNOLOGY	**1:15 p.m.**	**Adams**
REPORTING REALITIES: OVERCOMING TODAY'S BIGGEST CHALLENGES	**2:15 p.m.**	**Adams**
TECHNOLOGY SOLUTIONS SHOWCASE – SOLUTION INTRODUCTIONS	**3:10 p.m.**	**Adams**
BREAK – TECHNOLOGY SOLUTIONS SHOWCASE –SESSIONS 1	**3:30 p.m.**	
ADVENT		**Water Tower Parlor**
CABINET		**Medinah Parlor**
INVESTCLOUD		**Hancock Parlor**
NORTHERN TRUST		**Grant Park Parlor**
PCR		**Millenium Parlor**
SOLVER		**Adams**
SUNGARD		**Wrigley Parlor**
WEALTHTOUCH		**Spire Parlor**
PEER DIALOGUE BY TOPIC:		
FAMILY EDUCATION	**4:00 p.m.**	**Monroe**
HUMAN CAPITAL	**4:00 p.m.**	**Spire Parlor**
CYBER SECURITY	**4:00 p.m.**	**Adams**
D&O/E&O INSURANCE	**4:00 p.m.**	**Water Tower Parlor**
TECHNOLOGY SOLUTIONS SHOWCASE – SOLUTION SESSIONS 2	**5:00 p.m.**	**See above**
ADJOURNMENT	**5:30 p.m.**	
NETWORKING RECEPTION	**5:30 p.m.**	**Adams Foyer**
EVENING CONCLUDES	**7:00 p.m.**	

Agenda (Continued)

Wednesday, July 23

BREAKFAST	**7:30 a.m.**	**Monroe**
OPENING COMMENTS	**8:15 a.m.**	**Adams**
TAX AND ESTATE UPDATE	**8:30 a.m.**	**Adams**
BREAK – TECHNOLOGY SOLUTIONS SHOWCASE – SESSIONS 3	**10:00 a.m.**	
ADVENT		**Water Tower Parlor**
CABINET		**Medinah Parlor**
INVESTCLOUD		**Hancock Parlor**
NORTHERN TRUST		**Grant Park Parlor**
PCR		**Millenium Parlor**
SOLVER		**Adams**
SUNGARD		**Wrigley Parlor**
WEALTHTOUCH		**Spire Parlor**
FINANCIAL EXECUTIVE DIALOGUE:		
SMALL OFFICE	**10:30 a.m.**	**Monroe**
MEDIUM OFFICE	**10:30 a.m.**	**Spire Parlor**
LARGE OFFICE	**10:30 a.m.**	**Adams**
MFOs, THOUGHT LEADERS & WEALTH ADVISORS	**10:30 a.m.**	**Wabash, 3rd floor**
HUMAN CAPITAL TRENDS AND INSIGHTS	**11:45 a.m.**	**Adams**
CLOSING COMMENTS	**12:25 p.m.**	**Adams**
ADJOURNMENT	**12:30 p.m.**	**Adams**

Sixth Floor: Palmer House Hilton



Technology Demos
July 22 - July 23

Advent - Water Tower Parlor
Wealth Touch - Spire Parlor
Sungard - Wrigley Parlor
PCR - Millennium Parlor
Northern Trust - Grant Park Parlor
Investcloud - Hancock Parlor
Cabinet - Medinah Parlor
Solver - Adams Room

Peer Dialogue by Topic
July 22

Cyber Security - Adams Room
Family Education - Monroe Room
D&O/E&O Insurance - Spire Parlor
Human Capital - Water Tower Parlor

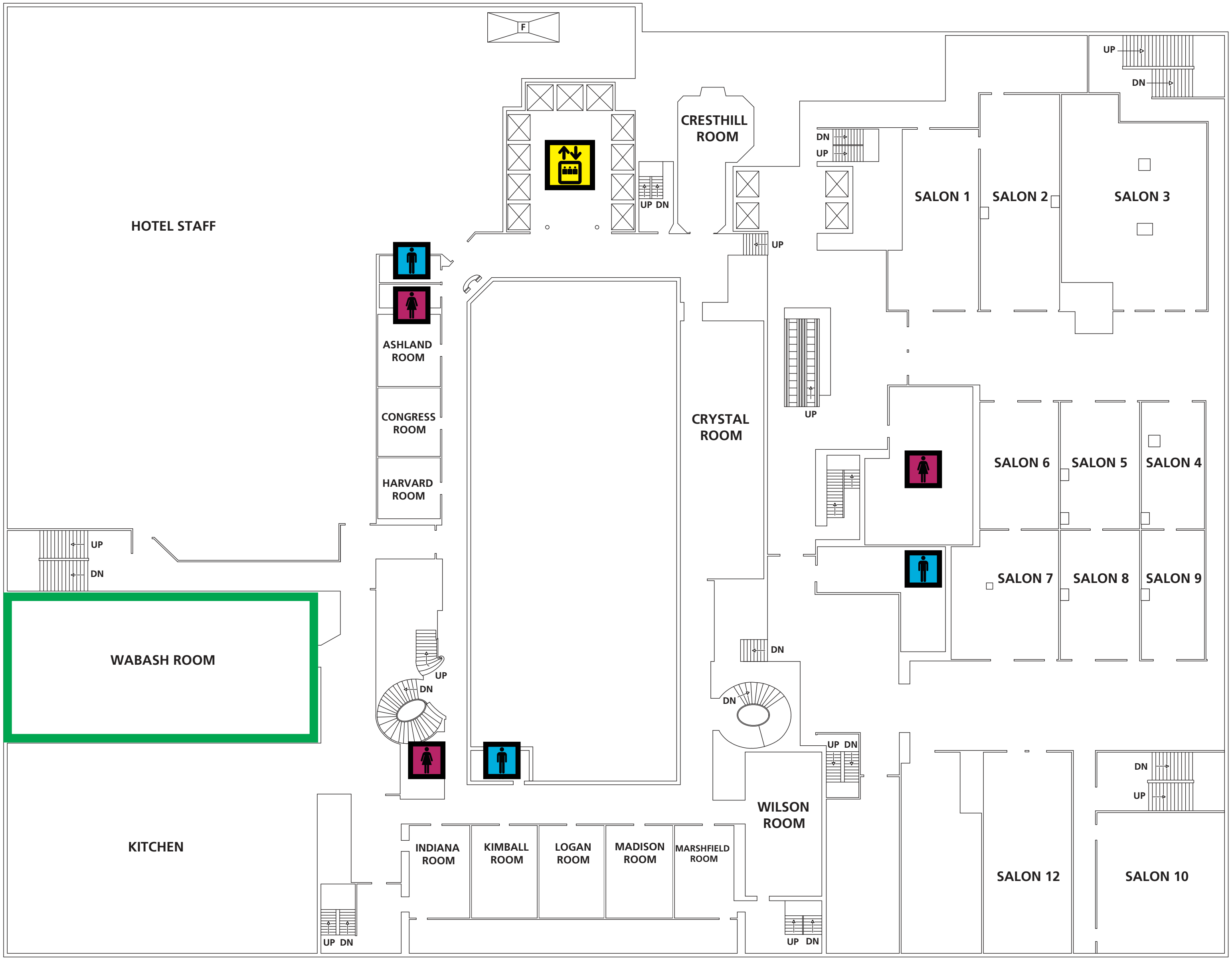
Peer Dialogue by Office Type
July 23

Small SFO - Monroe Room
Medium SFO - Spire Parlor
Large SFO - Adams Room

***Meals will be served in the Monroe Room.**

Family Office Exchange

Third Floor: Palmer House Hilton



Peer Dialogue by Office Type
July 23

Multi-Family Office / Thought Leader / Wealth Advisor - Wabash Room

Don’t Start at Square One – Implementing Technology

Join this session to hear a family office’s first-hand account of implementing new general ledger and CRM technologies. The Duchossois Group family office joins consultants from Infograte, Hale Solutions and Sikich LLP to share highlights and lessons learned from the project.

Jenny Hager
Director of Strategic Asset Management, The Duchossois Group, Inc.

Jenny Hager works in the family office for the Duchossois Family in Chicago. Jenny is Director of Strategic Asset Management, a division of The Duchossois Group, Inc. In addition, Jenny is Assistant Treasurer, Compliance Director and Trust Officer of Travers Trust Company LLC, a private trust company chartered in South Dakota.

Prior to joining the Duchossois family office in 2012, Jenny worked at Harris myCFO as a manager in their tax group with a focus on servicing single family offices.

Todd Heemsoth,
President, Hale Solutions, Inc.

Todd Heemsoth is founder and president of Hale Solutions, Inc. a technology consulting firm that specializes in helping its clients improve business processes with technology. He has more than 20 years of experience as a CPA, information technology consultant and software architect. Todd works closely with his clients to understand their unique needs and tailors solutions that deliver greater simplicity, agility and business value.
Todd founded Hale Solutions, Inc. in 2004 and since that time has helped many single and multi-family offices adopt new technology, change business processes to gain efficiencies, design software bridges to connect disparate systems and develop automated systems that perform financial, investment and performance reporting. Hale Solutions is a Microsoft Gold Certified partner.

Lyndy R. Januszewski, CPA
Managing Consultant, Sikich, LLP

As a registered Certified Public Accountant working in the Technology division at Sikich since 2007, Lyndy Januszewski bridges the gap between accounting and technology to ensure businesses, non-profits, and governments alike increase profitability, improve efficiencies, and achieve results. Currently, Januszewski serves as a Managing Consultant at Sikich and is responsible for managing projects and leading team members in their commitment to provide clients with exceptional service. These projects are mainly related to Microsoft Dynamics GP, an enterprise resource planning software for middle market companies.

Tania Nield, Ph.D.
Founder and CEO, InfoGrate, Inc.

Dr. Tania Neild is the Founder and CEO of InfoGrate, Inc., a consulting company specializing in information technology solutions for the financial services sector. Dr. Neild has established successful web-based information exchange solutions for clients from the Fortune 100 down to start-ups. InfoGrate supports all aspects of holistic information management, including technology specifications, tool selection and design, data feed integration, operations, data warehousing, reporting, and maintenance.
Dr. Neild's extensive web deployment experience enables her to consult on complex issues such as crossing applications for general ledger systems, analyzing security master attributes, modeling or tracking relationships, and managing tax or partnership accounting. Within technology infrastructure, InfoGrate has deep domain expertise with the design, customization, and implementation of new technologies and services to align strategic business objectives with tactical requirements, including compliance, disaster recovery, file management, security checks, and vulnerability assessments.

Notes:

Don’t Start at Square One – Implementing Technology

Case Study: A 4G SFO Restructuring Technology

Panelists:

Jenny Hager, CPA, Director	**Dr. Tania H. Neild,** Ph.D., President	**Lyndy R. Januszewski,** CPA, Managing Consultant	**Todd A. Heemsoth,** CPA, President
THE DUCHOSSOIS GROUP	INFOGRATE INCORPORATED	Sikich	HALE SOLUTIONS INC.

July 22, 2014 FOX Financial Executives Forum



SFO Details: Setting the Stage

12 Households

(1st through 3rd generations)

7 Employees

160 Legal Entities

600 Bank & Brokerage Accounts

Operating Business

Case Study Outline: A GL Implementation

Assessment

Strategy

Project 1: GL Upgrade

Project 2: CRM

Motivation: Issues that Started the Revamp

Why Get an Assessment?

- Goal to be Best in Class SFO
- Manual Processes
- Limited Personnel

Why InfoGrate?

- FO Expertise
- Colleague Recommendations

Why GL before CRM?

- Security
- Reporting
- Operating Business Assessment

Planning

Assessment

- Specific Need or Blind
- Balance Apps/Infrastructure AND People
- Pain Points

Strategy

- Consistency of Resolution, Architecture, Vendors
- EG. In house, Open Arch, MS SQL, Flexible, Best in Class or Hosted, KISS, Integrated…

Plans

- Priority
- Tactical aka Low Hanging Fruit
- Strategic

Sample Pain Points

Operations
Trade Exec
Recon/QC
Aggregation
Manual Assets
GL Accting

Investments
Rebalancing
Due Diligence
Fund Mgmt

Service
Communication
Foundation
Task Mgmt
Workflows

Horizontal
Document Management
Training or Accountability
Risk Management

Technology
Access and Security
Network, Infrastructure, DR

Planning

Checks

- Strategy
- References
- 50% Features - 50% Service. Check both

Budget

- 70% Service
- 20% On- Going

Timeline

- Is the Team Ready (Time) and Motivated (Pain)?
- Do you understand the plans and priorities?
- Measured

Kick Off: GL Project Overview

Family Office

- Sponsor (Christine)
- Project Manager (Jenny)
- Power User (Nina)

InfoGrate, Inc

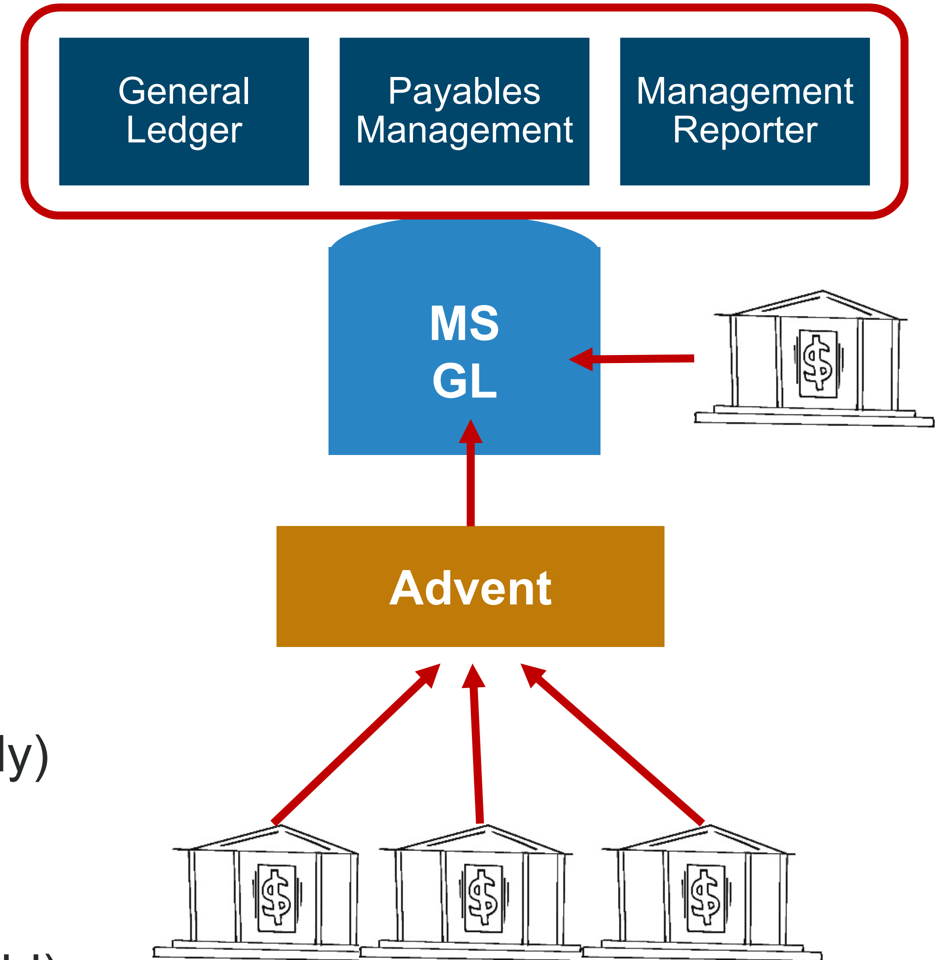
- CTO (Tania)
- Subject Matter Expert (Tara)

Sikich LLP

- Vendor Project Manager (Lyndy)

Hale Solutions, Inc.

- Vendor Project Manager (Todd)
- Developer / Programmer (Scott)



GL Parts: Microsoft Dynamics GP

Family Office Exchange

Phase 1 Modules			Future Phase Modules		
General Ledger	Payables Management	Management Reporter	Positive Pay	Fixed Asset Management	Electronic Funds Transfer
Bank Reconciliation	Intercompany	Multicurrency Management	Analytical Accounting	Revenue/Expense Deferrals	Receivables Management
Lockbox Processing	Refund Checks	Human Resources	Payroll	Sales Order Processing	Inventory Control
Purchase Order Processing	Manufacturing	Returns Management	Project Accounting	SmartList Builder	Integration Manager

Sikich®

GL Parts: Solution Implemented

- General Ledger
- Payables Management
- Management Reporter

Microsoft Dynamics GP

- Multi-Entity Management

Binary Stream

- Advanced Bank Reconciliation

Nolan Business Solutions

- MICR Check Printing
- Multi-Batch Print & Post

Mekorma

- Excel Integrator for GL and AP

Infinia

- SmartFill

Rockton

- Config AD
- Audit Trail
- Audit View

Fastpath

- SmartConnect

eOne Business Solutions

From Vendor's Perspective: Implementation Steps

COA Proof of Concept → Scope & Requirements → COA Design & Explosion

20 Digit Chart of Accounts Coding

F G WWW	+	EEE	+	C	SC	#####	+	TT	PP
0 1 001		IND		A	MM	12345		CN	NT

Family F
Tom= 0

Generation G
G1 = 1

W/I Generation
WWW
1^{st} B= 001

Entity Type EEE
(Indiv, Entity, Found, Trust)

Category C
Asset, Liability

Sub Category SC
Cash, MM, Mrkable

Account Sub Type
#####
Acct or Loan#

Type TT
Contr, Distr, Tax

Provider PP
Cust, Source

From Vendor’s Perspective: Implementation Steps

COA Proof of Concept

Scope & Requirements

COA Design & Explosion

Installation

Configuration

Data Conversion

Data Conversion

Imported Master Records

- COA
- Vendors

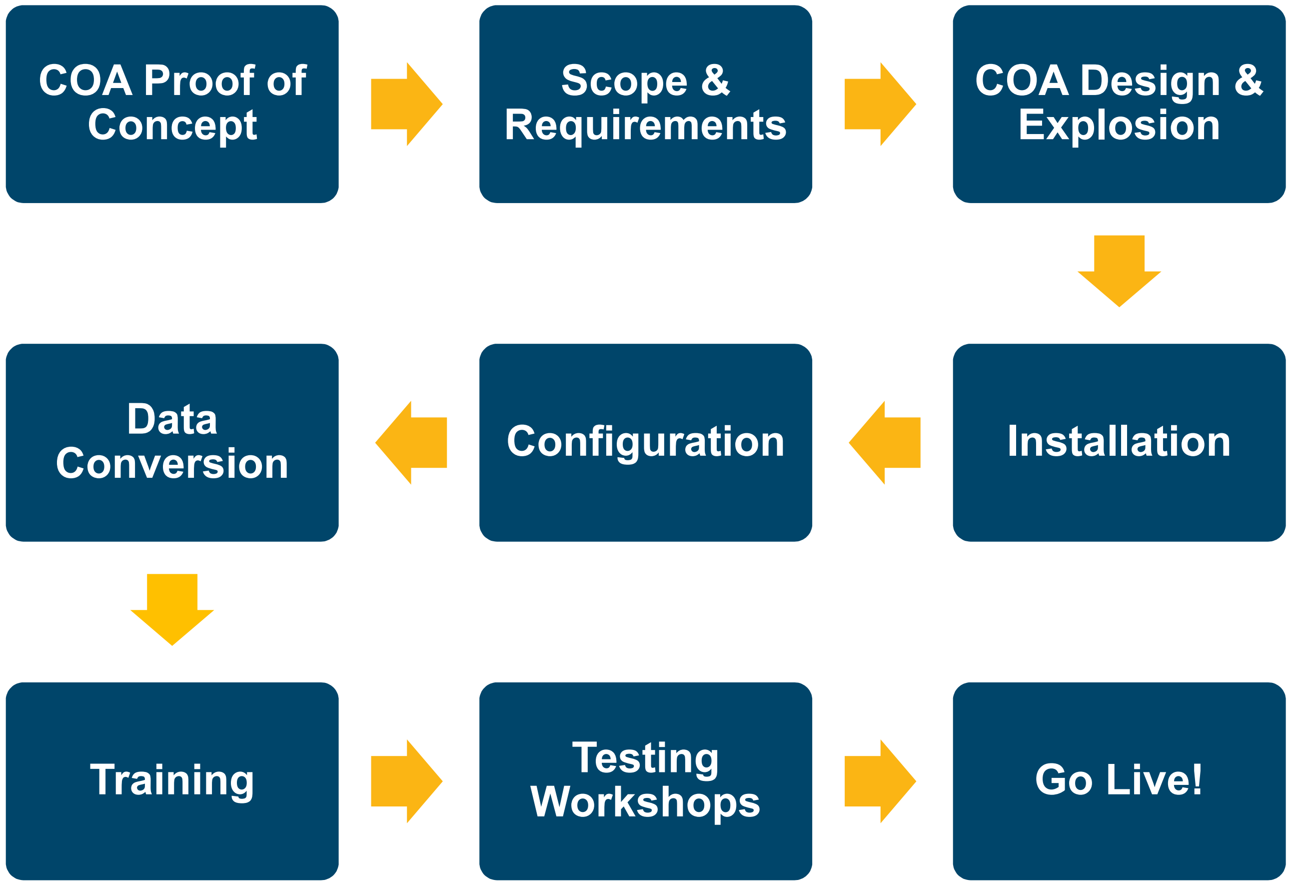
Imported GL Activity

- 12/31/2009 = Ending Balance
- 12/31/2010 = Net Change for the Year
- 12/31/2011 = Net Change for the Year
- 12/31/2012 = Net Change for the Year
- 1/1/2013 – 12/31/2013 = Net Change Quarter by Quarter
- 1/1/2014 – 3/31/2014 = Net Change Quarter by Quarter

What Was Not Converted

- AP Historical Transactions
- Open AP = $0

From Vendor’s Perspective: Implementation Steps



Integration: Monthly Investment Journal Entry

Advent Axys → Investment Accounting System (IAS) → Dynamics GP

- Portfolio Management System
- 280+ Investment Accounts Housed in Axys
- At Month-End, Reconcile Accounts and Export Data
  - ➢Transactions (dividends, management fees, etc.)
  - ➢Unrealized Gains & Losses
  - ➢Sales Proceeds with Short Term and Long Term Gains

- Map Axys Investment Accounts to 160+ GP Companies
- Map Axys Transaction Codes to GP DR and CR Accounts by Axys Account
- Import Axys Data
- Highlight Exceptions
- Create Journal Entry File Using Mappings and Axys Data

- Using SmartConnect, Import Journal Entry File Into GP as an Un-Posted Journal Entry
- Run GP Financial Reports Including Un-Posted Journal Entries and Review for Accuracy
- Post Journal Entry

Reporting

Who

- Households
- Advisors / Regulators
- Internal

What

- Balance Sheet
- Cash Flows
- Ad Hoc

When

- Monthly Print
- Quarterly Formal Presentation
- As Requested

Conclusion – Looking Back and Forward

Looking Back

- Current Status
- Lessons Learned
- Successes & Surprises
- Costs

Looking Forward

- GL Enhancements
- Report Delivery
- CRM Implementation

Questions and Answers

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Reporting Realities: Overcoming Today's Biggest Challenges

To make decisions about the future, families need reports that provide a full view of their integrated risk exposure and their allocation across all family entities. Yet such aggregate reports remain the elusive Holy Grail of our industry. It is often promised by product providers, but product capabilities often still fall short of expectations. One of the key questions becomes: What are the manual bridges that an office or outside provider should still be prepared to provide to produce a truly consolidated and functional report that provides useful information about holdings, performance and risk? In this session, speakers will talk frankly about the most challenging reporting issues for families with complex wealth. They will share their first-hand experience on what is required for creating comprehensive reports that enable decision makers to continuously monitor performance and change in value of assets at both the family and individual entity level.

Mark Rogozinski
President, Rockit Solutions, LLC

Mark Rogozinski brings more than 20 years of experience in various senior-level positions, with a particular focus on the ultra-high net worth space. Mark is a Managing Director of Rockefeller & Co. and President of Rockit Solutions, LLC, an outsourced solution that provides wealth data aggregation and financial reporting solutions for single-family and multi-family offices, high-net-worth individuals and financial institutions. Prior to joining Rockit in 2009, Mark was a Senior Vice President of Corporate Development at WealthTrust, where he was responsible for acquisition development and strategic relationships with other wealth management firms. Before joining WealthTrust, Mark was a partner and Chief Operating Officer for Homrich & Berg, Inc., where he was responsible for the direct management of client service, technology, operations and finance. Mark has also served as the Chief Operating Officer at Lydian Wealth Management and Senior Vice President and Chief Financial Officer of Atlantic Trust Pell Rudman.

Rebekah Kohmescher, CFP,CPA
Managing Director & Director of Investment Operations, Altair Advisers LLC

Beka has been providing tax and investment consulting to wealthy families and individuals since 1999. As a Founding Partner and Managing Director of Altair Advisers, Beka helps clients develop investment plans, recommends managers and tracks investment performance. In her role as Director of Investment Operations, Beka works to increase communication between various groups at Altair, creates efficient workflow patterns and facilitates projects
to develop new tools and reporting capabilities for both clients and employees. She assists with creating policies related to compliance and information filing with the SEC. She also manages the Consultants, Investment Operations and Client Reporting and Operations.

Sophia Stratton
Chief Financial Officer, Levy Family Partners

Sophia Stratton is the Chief Financial Officer of Levy Family Partners, a position she has held since January 2006, and currently serves as CFO and Treasurer of Levy Acquisition Corporation, a special purpose acquisition vehicle listed on NASDAQ. Prior to that time, Ms. Stratton was Controller for the Levy family's restaurant operations. In these capacities, Ms. Stratton established the accounting and tax policies, practices and procedures at the parent and subsidiary levels of the Levy family investment portfolio, including operating, real estate, and passive entities. In addition, she oversees treasury, human resources and benefits, risk management, purchasing, investment performance, IT, forecasting, estate and tax planning. She is a Manager of Levy Family Partners, a member of its Investment Committee, and has provided consulting services to several portfolio companies. Prior to joining the firm, Ms. Stratton was a Chief Financial Officer in the health care industry, preceded by a senior management position at Crowe Horvath, an international consulting and public accounting firm. While at Crowe, Ms. Stratton developed, managed and marketed tax, business assurance and operational consulting services.

David M. Bauer,
Chief Financial Officer, Lubar & Co.

Dave Bauer has been the Chief Financial Officer and a partner with Lubar & Co, a Milwaukee based single family office, since 2005. He is involved in the private equity activities of the firm and is on the board or working closely with the portfolio of companies including American Pasturization, Chem Design, Shared Imaging, Lake Express, Erdman, Drilltec, Rockland Industrial Products, and Zero Zone. Prior to this, he was the CFO for Facilitator Capital Fund, a Wisconsin-based Small Business Investment Company. He started his career with Arthur Andersen where he eventually led the Wisconsin transaction advisory services practice.

Notes:

Lubar & Co.

Family Office Exchange

Reporting Realities – Overcoming Today's Biggest Challenges

David Bauer, CFO, Lubar and Co

FOX Financial Executives Forum – July 23, 2014

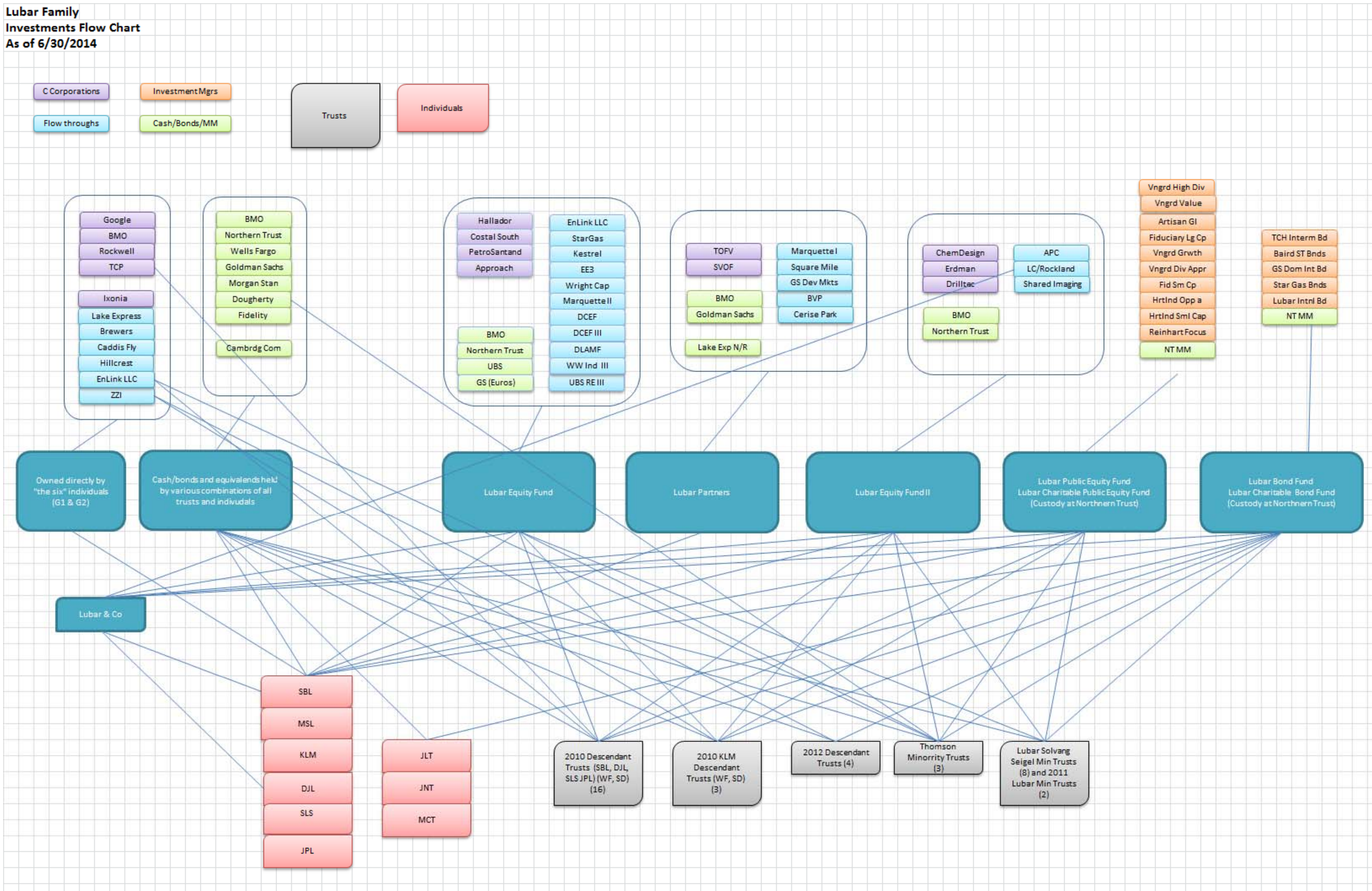
The Lubar Family Office Value Proposition

- **Family Leadership –** Led by members of the Lubar family and devoted to managing assets of the family
- **Superior Long-Term Returns** - Well in excess of what could be generated individually (private equity focus)
- **Outcomes / Legacy** – Charitable & Personal
- **Top Talent** – Responsive, Professional Team with the Highest of Integrity
- **Efficient / Low Cost** – Under 50bp on a tax effective basis (including all manager fees for public and private equity)

Lubar & Co.

- **External is NOT = to Internal Needs**
- **External**
  - Insight and Readability
  - Keep is simple
  - Returns by Category, Activity, Allocation
- **Internal**
  - Focus on managing pooled partnerships
  - Performance, attribution, risk metrics
  - Very detailed to drive action

Our Challenge … Turning This…



Lubar & Co.

Into This…. (Internally)

Lubar Group Financial Summary
For the five months ended May 31, 2014

	Lubar Equity Fund	Lubar Equity Fund II	Lubar Partners	Lubar Nominees: Cash/FI	Lubar Nominees: Public Stock	Lubar Nominees: Private	Lubar Taxable and Charitable Taxable Funds	Lubar Public and Charitable Public Equity Funds	Lubar Family Foundation	Eliminations **	TOTAL LUBAR GROUP
FMV As of December 31, 2013											
Dividends, Interest, Realized Gains and other Earned Income											
Realized gain on EnLink merger ($2.06/share of XTXI)											
Realized gain re: Debt repayments received from WWC											
Unrealized Gains(Losses)											
Approach Resources											
EnLink/Crosstex Inc.											
Hallador											
Lubar Capital/Rockland											
Shared Imaging (Tax Distribution)											
Wrightwood Capital											
Zero Zone Inc. (Tax Distribution)											
Lubar Taxable/Charitable Taxable Fund											
Lubar Public/Charitable Public Eq Fund											
Retirement (net)											
Other											
Total Unrealized Gains(Losses)											
Other Income(expense)											
Taxes Paid											
Charitable Gifts Paid											
Consulting Fee Expense (WTD)											
Other (Professional fees, insurance, etc)											
Total Other Income(expense)											
Follow on Investments											
Cash Distributions (Paid)/Received											
Payment of SPA to Lubar & Co.											
Investment in LTF, LCTF, LPEF, LCPEF											
Personal Draws (net of contributions of $276k)											
FMV As of May 31, 2014											

NOTES:

** Reduced prior period balance by $2.5MM to properly reflect FMV of investment in Milw Brewers. FMV should have been reduced from $9.2MM to $6.7MM in December of 2012. .
This reduction was reflected in the Company Writeups but never recorded in QB. Impact is ($416,600) per person.

A Crosstex merged with Devon Enegry to form EnLink LLC. Received $2.06 per share of Crosstex or $4,720,780 and 2,288,292 shares of ENLC (one for one exchange with XTXI shares).
The per share price increased from $36.16/share on December 31st to $41.27/share on May 31st

B AREX increased from $19.20/share on December 31st to $19.52/share on May 31st.

C Hallador increased from $8.06/share on December 31st to $9.46/share on May 31st.

D Subordinated debt payment received in excess of cost basis is treated as a realized gain for tax purposes. Total debt payment received was $5.1 million.

E Primarily Federal 3rd & 4th Quarter estimated tax payments

F $56.7MM of Distributions for liquidation of High Mountain - of which $54.2MM was reinvested in the funds proportionate to the distribution

G Primarily realized gains generated in the Public Equity Fund due to sales for the HM liquidation. Total earned income in the Public Equity Fund is $8.9 million netted agains the unrealized losses in the Public Equity Fund of $7.2 million is a net gain of $1.6 million.

**** Eliminations**
Eliminations are made for outside ownership of the assets reported which are not included in the TOTAL ASSETS reported above for the Lubar Group.

This includes Linda Stone's 5% ownership of LTF, employees ownership of LEF and LEFII (less than 1% in each entity), Lubar & Co's ownership of LEF, LEFII, LTF, and LPEF. Lubar & Co owns approximately 1% of LPEF and LTF each and less than 1% of each LEF and LEFII (Special Income Allocation Earned is included in elimination). Financial reports for Lubar & Co are provided separately and its assets are not included in the summary

Or This…. (Internally)

Lubar Public Equity Fund - Flash Report December 31, 2013

December Activity: When consolidated, the value of the Lubar Public Equity Fund (LPEF) and the Lubar Charitable Public Equity Fund (LCPEF) is $ During the month of December, the LPEF and LCPEF increased in value by million, generating investment returns of 2.35%, which was .01% above the benchmark return of 2.34%. In December four of the strategies utilized by LPEF outperformed their respective benchmarks. Reinhart's performance was the best overall with an annualized return of 17.02% since inception which is 1.47% better than the benchmark of 15.55%. Fiduciary generated a retun of 3.40% in December which is the highest excess return for the month at 1.52% over the benchmark of 1.88%.

Fourth Quarter Results: Stronger than expected US economic news and perceived stability in Europe increased investor optimism and spurred performance of risk assets, including equity and credit oriented fixed income investments. The Total equity portfolio gained 7.92% in the fourth quarter. Within the US equity composite, large cap stocks outperformed their small cap counterparts for the quarter. Companies with strong balance sheets, earnings power and quality management were rewarded. Total US Large Cap Equity composite ($71 million in LPEF and LCPEF) gained 8.37%, 214 basis points behind the S&P 500 Index. Lubar's passive large cap high dividend manager contributed to results on both an absolute and relative basis, with Vanguard Div App ($20.3 million) outperformingit's benchmark by 83 basis points for the quarter. The largest actively managed portfolio (Fiduciary Large Cap) underperformed its benchmark (8.95 vs.10.01%) which can be attributed to weak stock selection, particularly within the Consumer Staples sector. Heartland Small Cap ($3.1 million) led all managers within the total US Small/Mid Cap equity composite on an absolute and relative basis, up 12.06% beating the index return by 276 basis points. Stock selection was primarily responsible for Heartland Small Cap's performance, as positions in both Conmed Corp, Invacare Corp and Pharmerica corp contributed to results.

For the year, the value of the fund increased by 29.2%.

Inception to Date Results: On an inception-to-date basis, the $ million of net cash cost on the combined LPEF and LCPEF has grown to $ million representing an increase in value of $ million or a 50.1% total return and 12.3% on an annualized basis or 1.0% lower than the benchmark. Inception-to-date results of each manager are graphed on page two of this report.

LUBAR PUBLIC EQUITY FUND

	Invest Date	Tax Basis	Cash Cost	December 31, 2013 Market Value	Appreciation (Depreciation)	MTD	QTD	YTD	3 Yr.	Annualized Since Inception
US Large Cap										
Artisan Global Opportunity	7/20/2011					2.14%	5.93%	25.76%		15.40%
MSCI All Country World Index						1.76%	7.42%	23.44%		10.34%
Fiduciary Large Cap Value	4/30/2010					2.90%	8.95%	31.85%	16.11%	14.37%
Russell 1000 Value						2.53%	10.01%	32.53%	16.06%	14.60%
Lubar Select Stocks	10/6/2010					1.86%	6.68%	22.11%	13.34%	13.93%
S&P HY Dividend Aristocrats						1.81%	7.92%	30.59%	16.29%	16.54%
Vanguard Dividend Appreciation	4/30/2010					1.94%	8.75%	28.83%	16.35%	15.35%
S&P HY Dividend Aristocrats						1.81%	7.92%	30.59%	16.29%	15.02%
US Small/Mid Cap										
Fiduciary Small Cap Value	4/30/2010					3.40%	8.50%	31.76%	15.48%	14.84%
Russell 2000 Value						1.88%	9.30%	34.52%	14.49%	13.43%
Heartland Opportunity All Cap Value	4/30/2010					1.55%	9.41%	35.80%	12.86%	13.66%
Russell 3000 Value						2.48%	9.95%	32.69%	15.93%	14.50%
Heartland Small Cap Value	4/30/2010					1.79%	11.98%	33.92%	13.91%	14.95%
Russell 2000 Value						1.88%	9.30%	34.52%	14.49%	13.43%
Reinhart Focused MidCap Value	4/30/2010					3.19%	6.19%	38.11%	17.00%	17.02%
Russell Mid Cap Value						2.74%	8.56%	33.46%	15.97%	15.55%
Cash and Cash Equivalents										
Northern Trust Treasury Money Mkt.	4/30/2010					0.00%	0.00%	0.01%	0.04%	0.05%
I Money Net Treasury & Repo Institutional						0.00%	0.00%	0.01%	0.01%	0.01%
Northern Trust Ulta Short Bond Fd.	12/31/2010					-0.09%	0.47%	0.78%	1.45%	1.45%
I Money Net Treasury & Repo Institutional						0.00%	0.00%	0.01%		0.01%
TOTAL						2.35%	7.92%	29.22%	11.72%	12.31%
Custom Benchmark						*2.34%*	*9.38%*	*30.82%*	*13.03%*	*13.30%*
S&P 500						*2.53%*	*#####*	*32.39%*	*16.18%*	*15.30%*

Green: Manager Generated Positive Return (line 1) or Greater than Benchmark (line 2)

Red: Manager Generated Negative Return (line 1) or Less than Benchmark (line 2)

And This…. (Externally)

FOR THE DAVID J. LUBAR FAMILY

Please treat this report as confidential

Contents

Selected Lubar Portfolio Companies

American Pasteurization Co. is a Milwaukee-based food processor that uses high-pressure processing (HPP) to make fresh foods safer, taste better and last longer. www.americanpasturizationcompany.com

ChemDesign Products provides specialty, custom, and toll chemical manufacturing for companies in the agricultural chemicals, consumer, energy, industrial and plastics industries. The company is headquartered in Marinette, Wisconsin. www.chemdesign.com

Erdman Corporation, based in Madison, WI, is one of the nation's leading healthcare planning, development and design-build firms, partnering with hospitals, integrated health systems and physician groups to provide optimal healthcare facility solutions. www.erdman.com

Drilltec, Inc. is a Houston, TX-based, industry leader in innovating, engineering and manufacturing critical protection products for the oil country tubular goods (OCTG) market. www.drilltec.com

Zero Zone, Inc., based in North Prairie, WI, is a designer and manufacturer of glass door refrigerated display cases and electrical distribution systems for supermarkets, convenience stores, drug stores, ice arenas and cold storage industrial applications. www.zero-zone.com

Rockland Industrial Products, LLC, based in Red Wing, MN, is North America's second largest manufacturer of laminated wood flooring for the trailer and intermodal container markets. www.rocklandflooring.com

Shared Imaging, LLC, is a leading, Streamwood, IL-based provider of CT, MRI and PET/CT imaging systems, services and equipment to hospitals and other healthcare providers. www.sharedimaging.com

Lake Express is based in Milwaukee, WI and is the first high speed ferry in the US. It carries passengers and vehicles across Lake Michigan between Milwaukee and Muskegon, Michigan in just two and one-half hours. www.lake-express.com

Ixonia Bank is a community bank based in Ixonia, Wisconsin. The bank serves the personal and business banking needs of communities in Waukesha, Dodge and Jefferson through its six branches. www.ixoniabank.com

March 2014

Dear David and Madeleine,

We are pleased to enclose your family financial statement package for the year ended December 31, 2013. The year was marked by significant progress with the investment portfolio which consists of nine Lubar owned private operating companies, thirty eight other direct investments, and twelve externally managed public equity and fixed income investment strategies that hold thousands of stocks and bonds.

Overall Financial Results

The 2013 investment results reflect increased value of your assets by [illegible] million or 23.7% to [illegible] million, from $[illegible] million as of December 31, 2012. Also during 2013, you made charitable contributions of [illegible] million, tax payments of [illegible] million, and draws and other payments of [illegible] million bringing your family's net asset value to $[illegible] million on December 31, 2013. The $[illegible] million investment return was primarily due to a (i) [illegible] million increase in the value of private companies (Zero Zone, Lubar Equity Fund and Lubar Equity Fund II), (ii) [illegible] million increase in the value of public stocks held by the Lubar Public Equity Fund and (iii) [illegible] million increase in the value of Crosstex, Inc.

Evaluating the asset allocation of each family member and trust continues to be critically important, especially in light of the increased risk of rising interest rates that could negatively impact fixed income portfolios. As of December 31, 2013, you have a 13.3% allocation to cash and fixed income, 31.4% to public stocks, and 55.4% to private equity. During 2013, your allocation to fixed income was reduced from 20.8% as of December 31, 2012, and that reduction was beneficial as the Lubar Taxable Fund (the fixed income pool) generated a negative 0.3% return for the year. Allocating a higher percentage to public equities in 2013 had a positive impact on your portfolio as the Lubar Public Equity Fund generated a return of 31.4%. Your private equity investments increased in value by 27.6% and we continue to believe that this allocation is the best and most confident means of creating significant wealth over time.

2013 Highlights

The Lubar & Co. team is focused on continuing to follow the principals of Professional Ownership and our Guiding Principles while generating outstanding returns for the Lubar Family that could not be achieved individually. Here are several highlights from 2013:

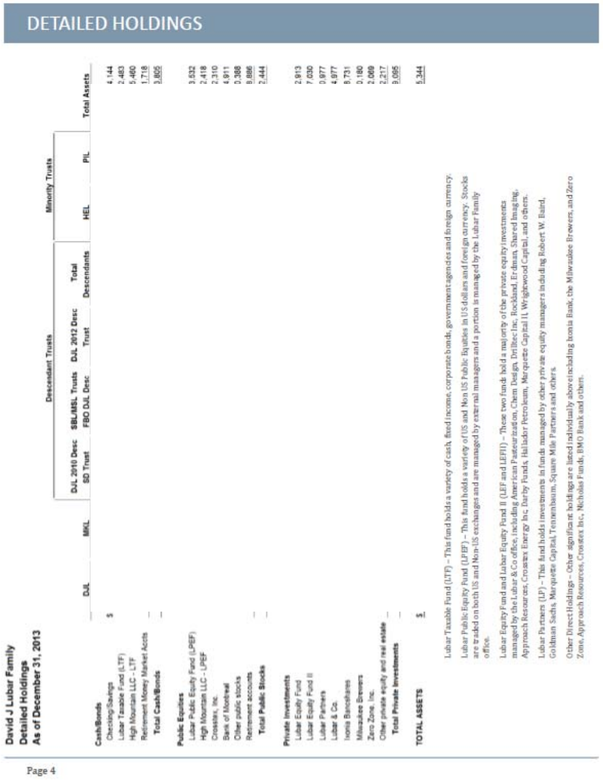
Lubar & Co.

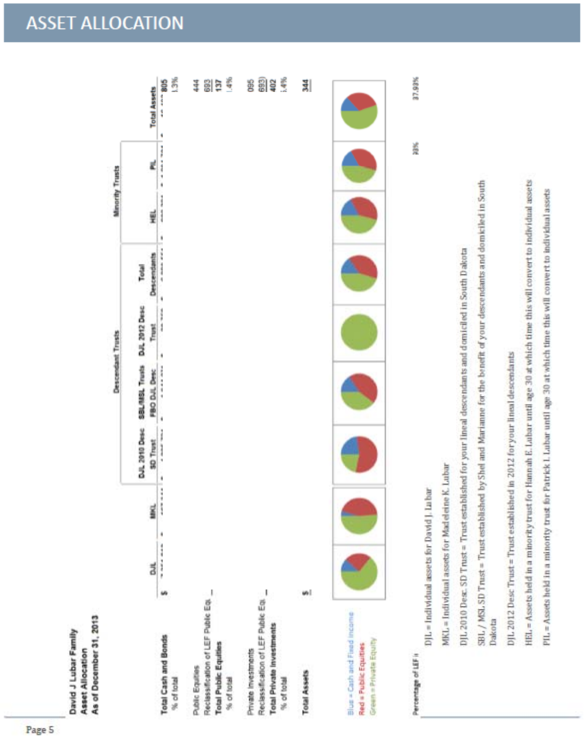
Financial Results & Performance…. (Externally)

- **23.7% Increase in Asset Value:** The value of your assets increased by 23.7% during 2013. The value of your investment in the Lubar Public Equity Fund increased by 31.4% and by comparison, the MSCI All Country World Stock Index generated a return of 23.4% in 2013. We achieved this superior return by focusing on US equities and proven managers we know well. The value of your private investments (LEF, LEF II and Zero Zone) increased in value by 27.6% through the diligent efforts working directly with each of the companies to improve cash flow, invest in growth initiatives, and continue to pay down debt prudently. The value of your fixed income (Lubar Taxable Fund) declined in value by 0.3% in 2013. While disappointing, this was 1.7% better than the negative return generated by the Barclays Capital Aggregate US Bond Index return of -2.0% due to the short duration position we have taken with fixed income.

- **Strong Private Company Results:** In the core group of Lubar private companies (American Pasteurization, Chem Design, Drilltec, Erdman, Rockland, Shared Imaging and Zero Zone), total revenues in 2013 were million and total Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) were million. We continue to invest in production facilities, process improvements, and have hired key new senior personnel at selected Companies (CEO and CFO at Shared Imaging, COO at Erdman, CFO at Lake Express). During 2013 the Companies also reduced their total debt by million to $ nillion, leaving substantial borrowing capacity available to finance growth and future acquisitions.

- **New Private Equity Investment Activity:** During 2012 we acquired four new platform companies (Ixonia Bank, Drilltec, Erdman and Chem Design) and in 2013 substantial progress was made building the foundation for the future. In 2013, we made one new investment and two follow on investments.
  - Follow on investment in **Rockland:** In December, we invested $ million to acquire the interest of our long-time partner Mass Mutual. This, combined with additional minority shareholder redemptions by Bill Donovan and the Nick Brady Family, increased the Lubar family ownership from 40.8% at the beginning of 2013 to 70.7% by the end of the first quarter of 2014. We are excited about the future prospects of this business.
  - New investment in **EE3** of $2.5 million: EE3 LLC was formed by Yorktown Energy Partners, a successful manager we have worked with for almost 20 years. EE3 is acquiring mineral rights and conducting exploration and drilling activities on land located in Jackson County Colorado.
  - Follow on investment in **Ixonia Bankshares:** A follow on investment million was made in Ixonia Bankshares. Earlier in the year, the bank received notice from regulators that they have lifted the regulatory consent order, which is a confirmation of its improved financial soundness which will enable a significant reduction in time and cost to manage the regulatory requirements of a consent order.





Lubar & Co.

Charitable Outcomes…. (Externally)

REPORT OF CHARITABLE OUTCOMES
FOR THE SHELDON B. LUBAR FAMILY
OCTOBER 2013

Please treat this report as confidential

October 2013

The Lubar family has long made philanthropic giving a priority. In the last five years, the Lubar Family Foundation has given almost $ 00,000 to hundreds of charities throughout Wisconsin, Minnesota and throughout the world. Gifts such as those to the Milwaukee Art Museum, the Milwaukee Jewish Federation, Milwaukee Film Festival, Planned Parenthood of Minneapolis, United Way, UPAF, the Milwaukee Bradley Beach project and the UW – Milwaukee Sheldon B. Lubar School of Business have directly improved the quality of life in our local communities.

Each year, your family makes tax deductible contributions to the Lubar Family Foundation and other charitable organizations. The amount of the annual giving has historically been determined so that the maximum tax benefit of the giving is achieved. Over the last five years, your total tax deductible contributions were $ 15,000, ranging each year from 100,000 to . Most of these gifts have been made to the Lubar Family Foundation.

Your fund in the Lubar Family Foundation has, in turn, gifted $,300 to charities over the last five years. You have given an additional $ 000 directly to certain charities as well. The detail of this giving, for the last three years, is included within this report. The current balance of your fund at the Lubar Family Foundation is $,000, which may be given to any public charity at your discretion.

For 2013, you need to make two decisions before the end of the year. Although the decisions are related, they are independent of each other.

1. First, do you want to give the amount that will maximize the tax benefit of your charitable contribution deduction, or would you like to give a lesser amount? Your current projected income for 2013 is 00. The minimum amount we recommend you give is a gift of appreciated stock that has a value of 200. To achieve the maximum tax benefit related to the charitable contribution deduction, you could give additional cash of $ 300 for total giving of 00.

   Given the current tax rates, you receive a tax benefit of $.50 for every $1.00 you gift. The benefit of giving appreciated stock is even higher because you also save paying the capital gains tax. In other words, a contribution of 000 results in a tax deduction of $ 00 and a net cost to you of $ 00.

HISTORICAL CHARITABLE GIVING

Sheldon & Marianne Lubar Charitable Fund

Lubar Family Foundation	2010	2011	2012	YTD 9/30/2013	TOTAL
Ohan					,000
88Nir					,000
ABCI					500
Ande					,700
Aspe					,550
Aspe					,000
Aspe					,200
Badg					,000
Battk					,000
Boy					,000
Brew					,000
City					,500
Cong					,300
Cont					,000
Danc					,000
Disc					,000
Disc					,000
Eastl					250
First					,750
Flore					,480
FOSA					250
Frien					,000
Gran					200
Grea					,000
Grea					100
Grow					,000
Hada					,000
Hagg					,500
Ice A					,000
Jewi					,267
Jewi					500
John					,000
Junic					,000
Lake					540
Louk					300
LISC					,000
Madi					100
MAJC					,000
Marq					,000
Medi					,000
MIAD					,000
Milw					,500
Milw					,000
Milw					,000
Milw					,500
Milw					,666
Milw					,612
Milw					,000
Milw					,000
Milw					,200
Mour					300
MPL					,000
MPTV					840
Muse					,500
Natio					100

Lubar & Co.

Peer Dialogue: Family Education

As one of the key trends impacting the family office industry, family education and learning have become essential service requirements. As indicated in the 2014 FOX State of the Art in Wealth Management report, family education is essential for the support of the family enterprise and is the responsibility of all stakeholders, not just primary stockholders. As such, the following key components of family education will be discussed:

- How is your team responding to this surge of interest and demand for family education?
- To what degree is your organization investing in family education?
- What family education do you provide, and by whom and how is it being delivered?
- What are your critical family education needs?

Amy Hart Clyne
Executive Director Market and Content Development, FOX

Amy Hart Clyne is Executive Director of the Family Office Exchange (FOX) Market and Content Development team where she works on delivering market-centric solutions to both Family and Advisor Members of the firm. She is an executive with extensive experience in private wealth management serving ultra high net worth individuals. A strategic and tactical professional, Amy is skilled in developing strategy, marketing and communications programs to both members of senior management teams and as an advisor to industry leaders in private wealth management. Specific areas of expertise include strategic planning, client management and advisory, strategic marketing and research planning, internal sales and training meetings, client events and seminars, relationship management, and new product launch.

Financial Executives Forum
Tuesday, July 22, 2014
Trends in Family Education

TREND #5

Family education and learning are becoming essential service requirements.

FOX Member Feedback Survey (2013)	FOX Family Office Benchmarking (2012)
Family Offices / Surveys	Family Offices / Benchmarking
#1 Future Programming Topic	**58%** Have or Plan to Have a Family Education Budget
Educating the Next Generation	Committed families spend **$100,000+** per year

20

Notes:

TREND #5

Providing Family Education and Learning Services

Family Office Exchange

FOX MFO Benchmarking (2014)	FOX State of the Art in Wealth Management (2014)

ADVISORS

Benchmarking

MFOs Budget for Wealth Owner Education

50%

86%
Institution-owned MFOs

31%
Boutique MFOs

Have or Plan to Have a Budget in 2014

COUNCILS

Research

State of the art family education is characterized by:

- Consensus that it is **essential** and **responsibility of all stakeholders**
- **Strategic approach** that includes leadership, governance, resource management, program design for groups, and **customized plans**
- **Well rounded** curriculum in **four dimensions**: family, business, finance and philanthropy

21

Notes:

TREND #5
RESPONSES

Providing Family Education and Learning Services

- Formalize wealth owner education by developing education plans and looking to work with consultants to assist in this process
- Develop a multi-year programmatic view of owner education

- Offers custom family education plans covering a broad range of topics and formats
- Leads family meetings on education topics
- Hosts in-person client events focused on education
(vs. on services and performance)

22

Notes:

Peer Dialogue Conversation – Family Education

As one of the key trends impacting the family office industry, family education and learning have become critical service requirements. The 2014 FOX State of the Art in Wealth Management report indicated that family education is essential for the support of the family enterprise and is the responsibility of all stakeholders, not just primary stockholders.

At your table, please discuss the following questions and choose a spokesperson to share your ideas, accomplishments, innovations and needs with the entire group.

- How is your organization responding to this surge of interest and demand for family education? To what degree is your organization investing in family education?

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- What family education do you provide, and by whom and how is it being delivered?

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- What are your critical family education needs?

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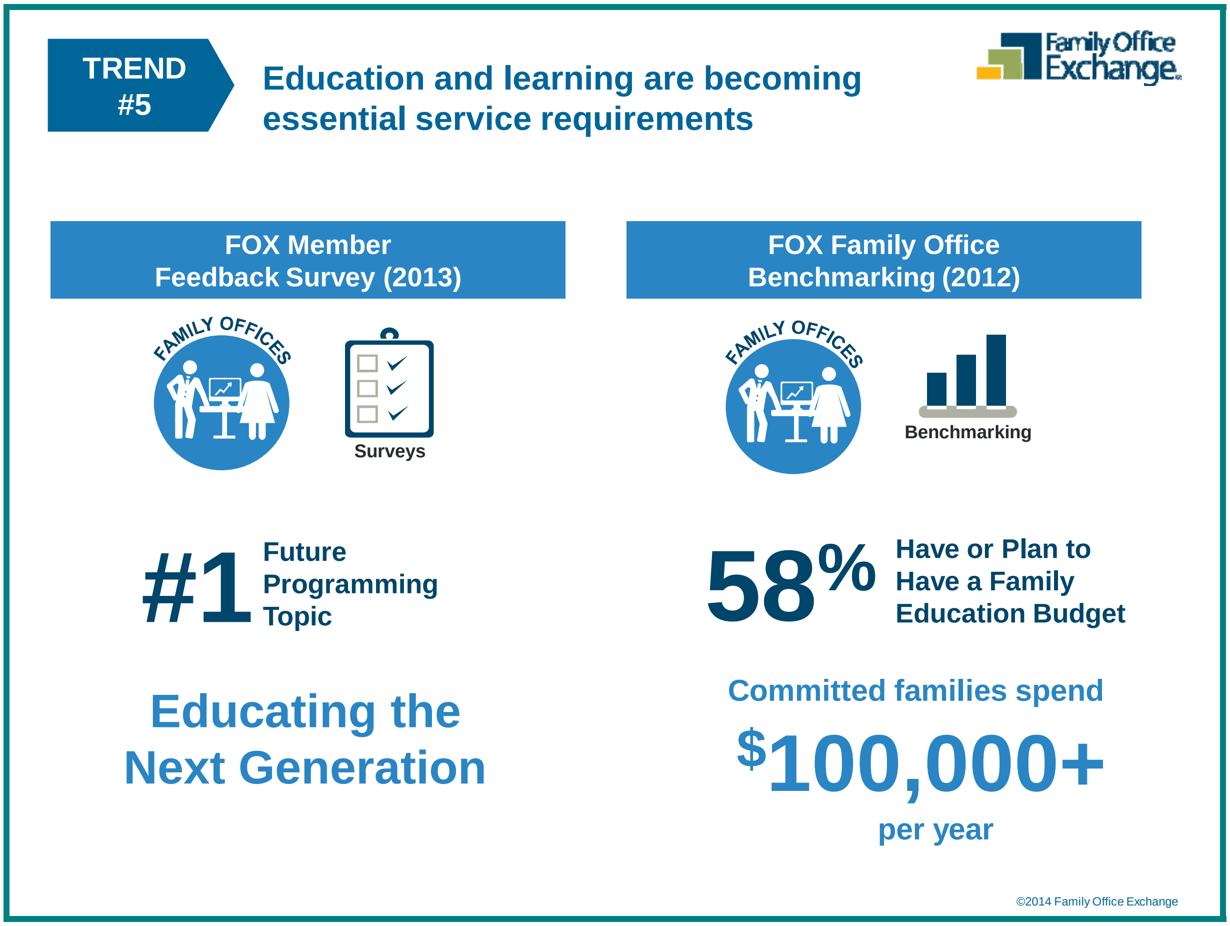
Peer Dialogue: Human Capital

Dawn M. Rose,
Director of Human Capital, FOX

Dawn collaborates with senior management to implement human capital strategy at FOX, including organizational design, talent acquisition, performance development and assessment, employee/labor relations, compensation, benefits, and legal compliance. She joined FOX from the University of Chicago, where she served as the Director of Human Capital for faculty and staff in the Department of Surgery. She has more than 15 years of experience in human resources and earned her Professional in Human Resources (PHR) certification from the HR Certification Institute in 1998. She graduated with her Juris Doctor from Chicago-Kent College of Law in 2007, where she also earned a Certificate in Labor & Employment Law. She has volunteered as a pro bono attorney for Equip for Equality, The Chicago Lighthouse for People Who Are Blind or Visually Impaired, and the Illinois Lawyers' Assistance Program, as well as serving on boards with the American Cancer Society – Chicago Chapter, The Chicago Lighthouse, and Sixty Inches from Center, a nonprofit organization that documents, archives, and engages with the visual arts community in Chicago.

Financial Executives Forum
Tuesday, July 22, 2014
Trends in Human Capital



Notes:

Education and learning are becoming essential for staff development and operational success

$1,195 Average Direct Expenditure per Employee on Training and Development per year

30.3 Training Hours Used Per Employee Per Year

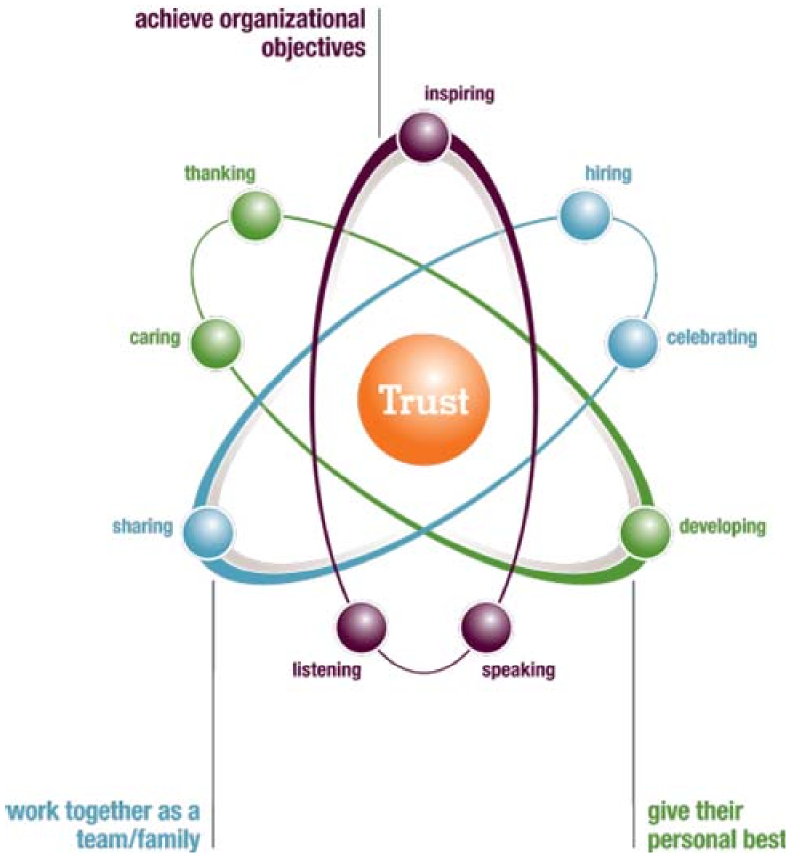
39.2% of Training Delivered Using Technology

$89 Average Cost Per Learning Hour Used

Leading Topics: Managerial & Supervisory; Mandatory & Compliance; Processes, Procedures & Business Practices

Source: Association for Talent Development 2013 State of the Industry Report

Notes:



What makes a Great Workplace?

Employee View
•**TRUST** in the people they work for
•**PRIDE** in what they do
•**ENJOY** the people they work with

Manager View
•Achieve **ORGANIZATIONAL OBJECTIVES**
•With employees who give their **PERSONAL BEST**, and
•**WORK TOGETHER** as a team/family in an environment of **TRUST**

Source: www.greatplacetowork.com

Notes:

Peer Dialogue Conversation – Human Capital

Among the key trends impacting the family office industry, education and learning has critical implications for client and employee satisfaction, as well as overall business success. The 2014 FOX State of the Art in Wealth Management report indicated that education and learning is essential for the support of the family enterprise and is the responsibility of all stakeholders, not just primary stockholders.

At your table, please discuss the following questions and choose a spokesperson to share your ideas, accomplishments, innovations and needs with the entire group.

- To what degree is your organization investing in education and development of its staff? What is your average investment of time and expense per employee?

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- What forms of education do you provide? Who provides it? How is it being delivered?

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- What are your office's critical education and development needs to make your office a Great Workplace?

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Peer Dialogue: Cyber Security

The following will be discussed:

- the controls and threats to the people (staff and family members)
- processes (formal and informal)
- technologies (current and future) in family offices

Joe Oleksak, CRISC, QSA
Information Technology Consulting Principal, Plante Moran
Joe has more than 16 years of information systems security and information technology audit experience in both our Family Office and Financial Institutions practice. Joe's experience includes: IT strategic planning, IT risk assessments, IT audit, global/local network security projects, web application security, PCI compliance, SOC reviews, incident response planning and business continuity and disaster recovery management. Joe is a member of the Information Systems Audit and Control Association (ISACA), and the International Information Systems Security Certification Consortium (ISC)². He attends and presents at multiple security and industry conferences annually and is a member of both the Indiana Bankers Association Information Technology Committee and the Illinois Bankers Association Technology Committee. Joe is a Certified Information Systems Security Professional (CISSP), Certified in Risk and Information System Controls (CRISC), and a PCI Qualified Security Assessor (QSA).

Doug Wiescinski
Partner, Plante Moran
Doug has more than 30 years of experience in information technology. His background includes systems design and development, technology planning, technology selection and contract negotiations. Doug serves a diversity of clientele including Family Offices providing strategic technical assistance in initiatives such as business process redesign, outsourcing analysis, network planning and integration. Doug is a member of the Society For Information Management (SIM), and a member of Automation Alley. Prior to joining Plante Moran, Doug was in charge of the business systems consulting services for Ernst & Whinney (now Ernst & Young) in western Michigan. He holds a BS degree in Management Information Systems from Ferris State University. In addition, he is a Certified Systems Professional (CSP).

Family Office Exchange

Financial Executives Forum
Tuesday, July 22, 2014
Cyber Security

plante moran

Cyber Security Agenda

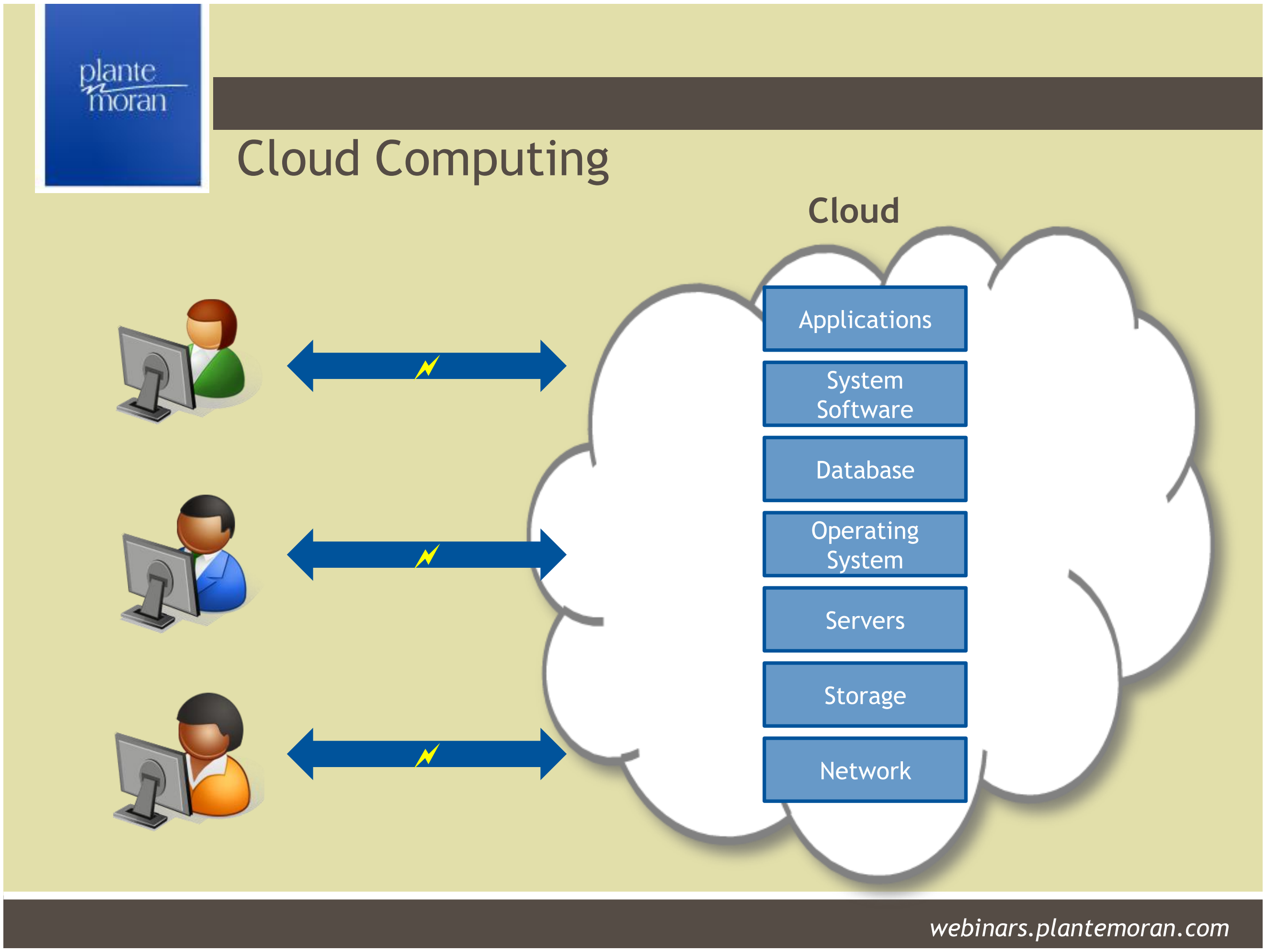
The People of Cybersecurity
- Responsibility for security
- Understanding the threat landscape
- Proper use of technology

The Processes of Cybersecurity
- Data and systems lifecycle
- Vendor Management
- Annual Cybersecurity Assessment

The Technologies of Cybersecurity
- Will depend on your culture
  - Commitment to control
  - Overall Risk tolerance
- Will depend on your budget
- Optimum Service Delivery Model
- Cloud Computing defined

webinars.plantemoran.com

Notes: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Cloud Computing
Cloud
Applications
System Software
Database
Operating System
Servers
Storage
Network
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Notes:

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Cloud Computing

Deployment Model

Public | Private | Community | Hybrid

Service Model

Infrastructure as a Service (IaaS) | Platform as a Service (PaaS) | Software as a Service (SaaS)

Characteristics

Resource Pooling | On-Demand Self-Service | Elasticity | Broad Network Access | Measured Services

Adapted from: NIST Visual Model

2

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Notes:

Peer Dialogue Conversation – Cyber Security

At your table, please discuss the following questions and choose a spokesperson to share your ideas, accomplishments, innovations and needs with the entire group.

- How is security viewed within your organization? Is it assumed as an IT responsibility only, or is it the responsibility for everyone?

- How is security included in major initiatives like selecting/implementing new technologies or systems, moving to the cloud and other third party initiatives?

- What cloud services are you considering? What security issues might arise based on your decisions?

Peer Dialogue: D&O/E&O Insurance – Family Office Liability

The following will be discussed:

- Family Office Best Practices
- Family Office Claims Trends
- Insurance Products Tailored to the Family Office

John Meade
Assistant Vice President, AIG

John Meade, Assistant Vice President, AIG, currently oversees the middle market Financial Institutions Portfolio for the New York and Atlanta Regions. In this role, John handles all aspects of AIG's financial lines strategy spanning Asset Management, Real Estate, Private Equity, Lending and Insurance Companies and leads AIG's team of underwriting professionals dedicated to these segments. John continues to assist in the implementation of key strategic initiatives within the Financial Institutions space.

John transitioned to this role from his position as Team Leader for the Asset Management team, handling the Atlanta, Boston and Philadelphia Regions. John began his career with AIG in 2011 and held various positions of increased responsibility within the Financial Institutions division during this time.

Abigail Geary
Assistant Vice President, Marsh Private Client Services, Family Office Group

Abigail Geary is currently a Senior Client Advisor in Marsh's Private Client Services, Family Office
Group serving clients nationwide. Abigail specializes in professional and management liability
insurance and risk for single and multi-family offices, private trust companies and individual trustees, as well as not for profit organizations. Abigail works hands on with her clients to understand their varied and unique needs and with the insurance markets to best address those needs. Abigail plays an integral role as a resource within the Private Client Services division of Marsh. She is a member of PLUS and is working toward the RPLU professional designation.

Financial Executives Forum
Tuesday, July 22, 2014
D&O/E&O - Family Office Liability

Family Office Exposures

How to think about liability in the Family Office context?

- Complex organizations
- Multiple operating entities
- Numerous professional services offered to family members
- A vast accumulation of wealth
- Highly compensated workforce

Increased liability for Employees of the Family Office

1

Notes:

Preventing Liability in the Family Office

Family Office Best Practices:

- Strong internal controls
- Audited financial statements
- Reputable and knowledgeable service providers
- Demonstrated record keeping and processes
- Experienced management
- High degree of transparency
- Sufficient financial resources to support operations

2

Notes:

Underwriting Considerations

- Overview and history of the family
- Clearly defined mission statement highlighting services provided
- First generation or multi-generation?
- Clear management structure with job descriptions and responsibilities
- Clear description of client service offering
- List of operating entities, trusts administered and funds managed
- Investment Performance of Assets Under Management

3

Notes:

Peer Dialogue Conversation – Family Office Liability

With a broad range of client services, family offices may find their exposure to risk even greater than the typical wealth manager. Like all directors, officers and professionals, family offices are at high risk of being sued for professional negligence, mismanagement of funds or employment discrimination.

At your table, please discuss the following questions and choose a spokesperson to share your ideas, accomplishments, innovations and needs with the entire group.

- How is your organization protecting Directors, Officers and Employees from potential liability? Has your Family Office thought about constructing a Standard Letter of Engagement that includes indemnification agreements?

- What procedures does your organization have in place to manage the complexity of the Family Office? How do you assess your service providers, operating entities, trusts and funds on an annual basis, if at all?

- How does the family office mitigate employment practices liability? Does your office keep pace with litigation trends and regulatory changes? If so, please discuss the steps taken to cope with such.

Tax and Estate Update

In our most in-demand session, experts will share the latest updates in estate laws and taxes that family office executives need to watch for in 2014 and beyond.

Thomas W. Abendroth,
Partner, Schiff Hardin LLP

Tom is a partner in the Chicago law firm of Schiff Hardin LLP and practice group leader of the firm's Private Clients, Trusts and Estates Group. He concentrates his practice in the fields of estate planning, federal taxation, and business succession planning. Tom is a 1984 graduate of Northwestern University School of Law, and received his undergraduate degree from Ripon College, where he currently serves on the Board of Trustees. He has co-authored a two-volume treatise entitled Illinois Estate Planning, Will Drafting and Estate Administration, and a chapter on sophisticated value-shifting techniques in the book, Estate and Personal Financial Planning. He is co-editor of Estate Planning Strategies After Estate Tax Reform: Insights and Analysis (CCH 2001). Tom has contributed numerous articles to industry publications, and served on the Editorial Advisory Board for ABA Trusts & Investments Magazine. He is a frequent speaker on tax and estate planning topics at banks and professional organizations. In addition, he is a co-presenter of a monthly teleconference series on estate planning issues presented by the American Bankers Association. Tom has taught at the American Bankers Association National Graduate Trust School since 1990. He is a Fellow of the American College of Trust and Estate Counsel.

James J. Steffel,
Partner, Warner Norcross & Judd LLP

Mr. Steffel serves as the Chairman of Warner Norcross and Judd's Family Office Industry Group. His practice focuses on high net worth succession and estate planning that frequently involves family entities, including the creation and maintenance of family offices. He recently spent two years helping a firm client roll-out its Multi-Family Office Subsidiary, while leading a dedicated Family Office Team as a Senior Wealth Advisor. Mr. Steffel has presented numerous seminars on estate and succession planning and he spent over a decade practicing law in a family business setting. He is preeminently rated by Martindale and Hubbell and he has been selected as a member of Best Lawyers in America, Leading Lawyers and Michigan Super Lawyers. Mr. Steffel received a B.S. in Business from Ferris State University, attended the University of Notre Dame London Law Center, and graduated in the top 10 of his class at both the University of Toledo College of Law (J.D. and Member of Law Review) and the University of Miami Law School (LL.M. in Estate Planning).

Sheryl Eighner,
Partner, PwC

Sheryl is a partner in the Personal Financial Services (PFS) group in Chicago. She has been providing income tax compliance and planning and financial planning services to her clients for over 15 years.
Sheryl's client base consists of private equity principals and partners, family offices, corporate executives and small business owners. Sheryl not only advises on income tax planning, but also cash flow, wealth transfer, succession, liquidity and insurance planning.
Sheryl has presented many financial planning and tax technical presentations throughout her career, wether they are in client "workshop/webcast" settings, or through outside organizations such as Women Leaders in Financial Services, National Association of Stock Planning Professionals and state CPA societies.

Notes:

Tax and Estate Update

Thomas W. Abendroth, Schiff Hardin LLP
Sheryl Eighner, PricewaterhouseCoopers LLP
James J. Steffel, Warner Norcross & Judd LLP

FOX Financial Executives Forum – July 23, 2014

Portability and $5 Million Exclusion

- Applicable exclusion amount: $5,000,000 indexed for inflation ($5,340,000 in 2014).
- GST exemption: also $5,340,000 in 2014.
- The unused exclusion of a deceased spouse (the "DSUE amount") can be transferred to the surviving spouse.
- Portability is available for estate and gift tax purposes, but does not apply to the GST exemption or for state death tax purposes (except in Delaware and Hawaii).
- Exclusion available is the DSUE amount of the last deceased spouse, so it can be lost.

Portability and Non-standard Families

- Multiple marriages with child from prior marriages.
- Portability allows surviving spouse to use DSUE amount as he or she wishes.
- Would family member make large outright bequest to surviving spouse?
- Choose personal representative carefully.
- QTIP Trusts and portability are dangerous combination.

Impact of State Estate Tax

- No portability of state exclusion (except Delaware and Hawaii).
- Use state exclusion amount at first death.
- In Illinois, $4,000,000 credit shelter trust. In New York, $2,062,500 (until 4/1/15). In Massachusetts, $1,000,000.

Planning with Portability

- Estates under twice the exclusion can use portability for a double basis step-up.
- Estates in the $10mm to $20mm range face the most difficult choices.
- Couples with significant wealth can use portability and then have the survivor create an irrevocable grantor trust to use the DSUE amount.

Clayton QTIP Trust

- John dies with $8,000,000, left to a QTIP trust for Jane.
- Elect marital deduction and portability. Jane gets $5,340,000 DSUE amount.
- Illinois couple. Elect marital deduction for $1,340,000 and portability. $4,000,000 non-elected amount. Jane gets $1,340,000 DSUE amount.
- Michigan couple. Elect marital deduction for $2,660,000. $5,340,000 non-elected amount.
- Non-elected amount can be shifted to family trust.

Final Net Investment Income Tax Regulations' Impact on Family Offices

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IRC 1411 Tax – Net Investment Income Tax

- The Patient Protection and Affordable Care Act of 2010 imposed on individuals, estates, and trusts a new Medicare tax, also known as the Net Investment Income Tax ("NIIT"), equal to 3.8% on Net Investment Income ("NII") starting in the 2013 tax year
- 1411 Proposed Regs issued in December of 2012.
- 1411 Final Regs issued November of 2013.
- Highest marginal rate on investment income is now 43.4%

Net Investment Income

1) Interest, dividends, royalties, annuities, rents

   (category 1)

2) Income from passive activities (category 2)

3) Trading financial instruments and commodities (category 2)

4) Net gains from sale of nonbusiness property and gains from no. 2 and 3 (category 3)

5) Earnings on working capital investments

NOT Net Investment Income

1) Active trade or business income exempt unless either passive or trading in financial instruments (hedge fund)

    -Gain and losses on sale of s-corp or partnership active interests

    -1231 property

    -self rentals properly grouped with trade or business

    -rental real estate professionals

2) Tax-exempt and municipal bonds
3) Retirement plan distributions
4) Tax deferred nonqualified annuities
5) Gains deferred or excluded (like kind, installment sales, inv. conv.)
6) Excludable gains (sale of home)
7) Deferral or disallowance provisions apply (i.e. capital loss c/o or passive loss c/o into 2013 will reduce NII)

Maybe Net Investment Income

National Principal Contracts (swaps) –

- 2012 regs. include as NII for trader funds but not for investor funds
- 2013 regs. Include as NII for both
- 2013 regs effective for years after 2013 – so for 2013 can choose which regs to use

- Working interest in oil and gas – generally not NIIT unless held through an entity that limits liability
- PFICs
  - QEF's/CFC's held through trader funds – NIIT assessed when income is earned – parallel to regular income tax
  - QEF's/CFC's held directly and through investor funds– NIIT assessed when distributions (instead of when income is earned)
  - Conformity election "G election" if desired (but applies to all QEF's/CFC's going forward per 2012 regs, but per PFIC on final 2013 regs. You pick for 2013…)

Updates reflected in the final & 2013 prop regs

- Gain/loss netting
  - NII now more closely matched to regular tax definitions; all gain/loss from trading and investing included in Category (iii) and limited to net gains
- Foreign taxes
  - No foreign tax credit allowed against NII; Foreign taxes reduce NII only to the extent a taxpayer uses them as a deduction for regular tax purposes, but not if using them as a credit
- Notional Principal Contract (Swap) income
- G Election for Controlled Foreign Corporations (CFCs) and Qualified Electing Funds (QEFs)

Material Participation

- Enactment of IRC 1411 allows taxpayers to revisit how they group activities for material participation standards
- 7 tests under IRC 469 to determine material participation (Reg §1.469-5T(a)
- Reg §1.469-4 allows you to group activities into “appropriate economic units”
- Reg §1.469-4(C)(2), provide the facts and circumstances are relevant in grouping
  - similarities and differences in types of business;
  - the extent of common control;
  - the extent of common ownership;
  - geographical location; and
  - interdependencies between the activities

Trust Considerations

- NIIT applicable if trust Modified AGI is $12,150 or more (indexed based on highest bracket) (except for grantor trusts)
- Final regulations allow trustees fees to be allocated to NIIT
- Frank Aragona Trust v. Commissioner case – trustees activities in a trade or business can count toward material participation. NIIT implications – might help crystalize "new proposed regulations" in this regard
- The application of the 3.8% tax gives planning opportunities to trustees: how do you allocate indirect expenses? How do you allocate DNI? Do you have flexibility in distributions?

Expense Allocations

- Regulations discuss ”any reasonable method” – so this gives some flexibility on allocation. Pro-rata or specific identification (especially relating to state income taxes and inv. management fees) can be used.
- What about expenses buried in K-1’s?
- Trusts have most flexibility as it relates to trustee fees and indirect costs – weighing beneficiary and trust liabilities

Summary

- Generally most items from pure trader funds will all be NII
- Generally, most items from investor funds will all be NII unless:
  - Fund holds CFCs/QEFs and a G election is not in place
  - Fund holds swaps treated as NPCs
- Generally, most items from fund of funds (aside from CFCs/QEFs and swaps) will be NII because LPs do not typically materially participate in the FOFs' trades or businesses
- Generally, rental real estate is passive unless you are a real estate professional or have self-rentals
- For operating businesses or private equity – determine material participation and groupings under IRC 469
- Consider expense allocation methodology
- Consider gifting to children – children get their own $200,000 of MAGI threshold

Final Income Tax Regulations' – IRC 67(e) – treatment of investment advisory fees

Legislative History

- History unclear
- Federal Circuit Courts of Appeal divided :
  - 6th circuit - investment advisory fees fully deductible
  - 4th circuit – investment advisory fees subject to 2% limitation
- IRS issued proposed regulations (July 2007) – stating inv. Fees are subject to 2% but did not require unbundling of costs
- 2008 Supreme Court Knight case – subject to 2% limitation and require unbundling of fees for those that are in excess of what an individual would incur
- Post Knight, IRS issued Notice 2008-32 stated for taxpayers to wait for final regulations – but don't unbundle in the mean time.

Final Regulations – how do I treat expenses?

– Final regulations (May of 2014) state that a cost is subject to the 2-percent floor if

i. it is included in the definition of miscellaneous itemized deductions,

ii. it is incurred by an estate or a non-grantor trust, and

iii. it would commonly or customarily be incurred by a hypothetical individual holding the same property.

– Ownership costs (aka Partnership holdings) – subject to 2% floor
– Tax Preparation fees for estate or trust– not subject to 2% floor
– Appraisal fees – not 2%
– Fiduciary expenses (probate, fiduciary bond premiums, etc.) – not subject to 2%

Final Regulations – how do I treat expenses?

- Trustees and executor fees –
  - Billed on an hourly basis – bifurcate based on those activities that are for services subject to 2% floor or not
  - Billed not on an hourly basis (bundled) – unbundle
- Investment Advisory fees – subject to 2% floor UNLESS it is an incremental cost due to the estate/trust – such as unusual investment objective in the trust/estate or the need for specialized balancing of the interests to various parties.
  - Final regulations require unbundling! Anything not computed on an hour basis and related to investment advice needs to be unbundled
- Unbundle based on "any reasonable method" Final regs provide some guidance:
  - the percentage of the value of the corpus subject to investment advice;
  - whether a third-party advisor would have charged a comparable fee for similar advisory services;
  - and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

WHY?

- Tax and Estate Planning Updates generally focus on what is new or in the news.
- Clearly Portability, the 3.8% surtax & the §67(e) Final Regs are:
  - (a) relatively new;
  - (b) in the news; and
  - (c) relevant to the entire audience.
- Covering Balance of Updates would be impossible, so we will simply review a few of the developments that appear most relevant to family office audits.

Top 8 Hot (& Not So Hot) Issues & Strategies

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- The topic impacts all & provides a chance to:
  - (a) reflect upon a few primary and newsworthy strategies; and
  - (b) determine which ones are adequately utilized and which ones are underutilized.
- More thorough update found in the outline & I will reference the outline as I cover the remaining Top 8 Issues & Strategies

8
APPRAISAL QUALITY & ACCURACY PENALTIES

- Polling: How Many Have Regular or Periodic Appraisals?
- Cases & Experience Establish Significant Variation in Quality of Appraisals
- Penalties Changed in 2006: 20% for ≤ 65%
40% for ≤ 40%
- See Richmond @ IV. B. (Self-impeached Draft Appraisal & Penalty)
- See Koons @ IV. E. Large Appraisal Adjustment (Bajaj - $117M to $110M to $149M) and Graegin

#7

PRIVATE ANNUITIES

- Polling: How Many Are Administering P.A.'s?
- Safe Statutory Guidance if Not Terminally Ill
- Physician Letter/Opinion > 50% Probability of 1 Year Survival
- See Kite @ IV. C. (Has stepped gift issues, but really a valid P.A. case)

#6

SELF-CANCELLING INSTALLMENT NOTES

"SCINs"

Polling: How Many Are Administering SCINs?

A. How many used an Interest Premium?

B. How many used a Principal Premium?

C. How many not sure?

- Basically an amortized Note that discharges balance owed at death.
- No previous safe harbors; several theories and cases (both ways) using mortality tables & premiums

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#6 SCINs cont'd

- See <u>Davidson</u> @ IV. D. (Docketed 6/14/13) & CCA 20130033
  - – CCA not binding – only advice from National Office to IRS Agents
  - – Now: Prior theories are challenged and a new proposed application of the willing buyer/willing seller test
  - – <u>Davidson</u> potential deficiencies of ≈ $900M + ≈ $1.8B
  - – Stay tuned . . .

#5
GRATS

Polling: How Many Currently Administering GRATs?

How Many Administering GRATs w/ ≤ 3 yr terms?

- Great for Anticipated Appreciation & Low Risk Tolerance (with or without income – although Appraisal challenges w/o)

#5 GRATs cont'd

- If appreciation fluctuates significantly – rolling S/T
- S/T (<10 yrs.) & zeroed-out on President's Fiscal Year 2014 Budget
- Google "GRATs Bloomberg": Zach Mider's Accidental Tax Break . . . . Sheldon Adelson: 30 Trusts = $7.9B to heirs - $2.8B taxes
- See Trombetta @ V. A. How to make a low risk technique fail through bad facts (administration)

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#4

Use of FLPs & FLLCs (Huge, but Not so Hot)

For Business & Asset Protection Purposes

Polling: How many have filed 709s or 706s attaching appraisals that recognize a valuation discount for lack of market and/or control?

- Decades of challenges & numerous theories (most success w/ §2036 & Present Interest (Hackl)
- If (a) Valid non tax purpose; (b) Properly formed and capitalized; and (c) Properly operated – side benefit = discounts because willing buyer/willing seller applies

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#4 Use of FLPs & FLLCs cont'd

- Latest Updates:
  - (2036) Turner, TC Memo 2011-209, underlying contributions to FLP includable via bad facts (poorly formed, capitalized & operated) and Kelly, TC Memo 2012-73, Guardians contributions to FLP, under court order, were not included via better formation, capitalization & operation facts
  - (Present Interest) See Wimmer @ IV. A. Facts meet present interest requirement – See Present Interest Continuum

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Hackl Extension of the Discount Continuum

No Discount	Greater Restrictions/ Greater Discount →	No Present Interest
Freely Trade (No transfer restrictions) Market for Sale History of Income Full Voting Rights	Restrictions on Transfers Poor Market for Sale Limited or Inconsistent Income	No Ability to Transfer No Market for Sale No Income Right or Expectation

New Present Interest Continuum

Present Interest

Cash

Wimmer 2012

Price 2010

Hackl 2002

#3
SALES TO IDIT OR IDGT

Polling: How many have compared GRATs to IDGT Sales?
How many have picked GRATs?

- Very Hot Topic with Davidson and Woelbing
- Previously Favorably Compared to GRATs (although not statutorily blessed)
  - With mortality complications instead of failure
  - Generally better performance via lower rates
    - July §7520 Rate: 2.2%
    - July AFRs: .31%; 1.82%; 3.06%
  - Great w/income producing assets to pay

#3 Sales to IDIT or IDGT cont'd

- Now could be next line of big attack
- Woelbing (Docketed as 30260-13 & 30261-13 on 12/26/13) with interesting commentary.
  - Carmex Lip Balm shares for $59M Note (@ AFR w/ Wandry-type dollar amount defined value)
  - IRS claims:
    1. Note = 0 via §2702
    2. Stock > $59M and diff = gift
    3. Stock in Mr. Woelbing's Estate via §2036
    4. $125M liability & $25M penalty
  - Like Davidson: wait & see

#2
USE OF FORMULA TRANSFERS

Polling: How many have used “finally-determined tax values” as the basis to determine the amount of a gift or value of assets sold?

Significant Taxpayer Progress in last decade

- Do not use value adjustment clauses: generally void against public policy – Procter. These try to change the amount transferred.
- Use value definition clauses. These fix the amount transferred and pour-over excess value to exempt (charity) transfer (McCord, Christianson, Petter)
  - Possible new Trombetta issue
- Consider fixed amount clauses (that transfer a dollar amount instead of a number of shares or a percent: (Wandry); Especially to Grantor Trust donees (to avoid income tax consequences from adjustments).

#1
GRAEGIN NOTES

Polling: How many are familiar with case?
How many have considered as liquidity strategy?

- Very situation specific (lack of liquidity)

Graegin:

- Key Requirements:
  - (1) Loan necessary for tax payment;
  - (2) Prohibition of prepayment

#1 Graegin Notes cont'd

- If appropriate: (1) Total interest "to be paid" is deductible expense and (2) w/o any present value adjustment
- Huge potential for abuse
- Duncan, TC Memo 2011-255. Road map for success. $20.6 deduct for reasonable $6.5M Note @ 6.7% (from NTC when AFR = 5.02% & Prime = 8.25%) over 15 yrs.
- See Koons, @ IV. E. Road map for disaster. $714M interest not allowed on unnecessary $10.75M Loan @ 9.5% with 18-year payment, deferral followed by 14 semi-annual $5.9M installments.

Summary

1. Plan for Portability and the new Net Investment Income Tax

2. Comply with the New Regs under IRC 67(e)

3. Use Quality Appraisals; Properly structure and administer Private Annuities, GRATs and Entities; Watch for developments on SCINs (Davidson) and Sales to IDGTs (Woelbing); Use Wandry or pour-over formula transfers (not value adjustment clauses); and be reasonable with Graegin

4. Questions & Answers

5. Thank you very much

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TAX AND ESTATE PLANNING UPDATE

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TAX AND ESTATE PLANNING UPDATE

I. Portability and the Increased Exclusion

A. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and the American Taxpayer Relief Act of 2012 changed the dynamics of transfer tax planning for the vast majority of wealthy taxpayers. The Acts increased the exemption amount for estate, gift and generation-skipping tax purposes to $5,000,000, indexed for inflation, and then made the increase permanent. They also added portability of the exclusion, providing a way to transfer unused gift and estate tax exclusion to the surviving spouse.

B. Basic Portability Provision and Scope

1. Section 2010 of the Code, as amended by Sections 302(a)(1) and 303(a) of the Tax Relief Act of 2010, creates portability by introducing the concept of "deceased spousal unused exclusion amount" ("DSUE amount").[1] Section 2010(c)(2) defines the applicable exclusion amount as "the sum of (A) the basic exclusion amount, and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."

2. Portability is available without regard to the size of the estate of the decedent or the reason for the decedent having unused exclusion amount.

a. A 2014 decedent with a $2 million estate, all left in taxable form, leaves $3.34 million of DSUE amount (exclusion that is portable).

b. A 2014 decedent with an $18 million estate, who leaves $2 million to his children and $16 million to his spouse and charity, also leaves $3.34 million of DSUE amount.

3. The definition of applicable exclusion amount also applies for gift tax purposes. The 2010 Act amended Code Section 2505 (Unified Credit Against Gift Tax) to define the credit for gift tax purposes by reference to "the applicable credit amount in effect under section 2010(c) which would apply if the decedent died as of the end of the calendar year."

[1] In temporary regulations published on June 18, 2012 (T.D. 9593), the IRS chose to use the term "DSUE amount." The temporary regulations are effective June 15, 2012. See Temp. Reg. §§20.2010-1T to -3T; 25.2505-1T to -2T.

Thus, a surviving spouse may use his or her enhanced applicable exclusion amount for gifts.

4. Portability does not apply to the GST exemption. Section 2631(c), as amended by the 2010 Act, defines the GST exemption amount as equal to "the basic exclusion amount under section 2010(c)."

5. The basic exclusion amount of $5,000,000 is adjusted for inflation beginning in 2012. IRC § 2010(c)(3). The basic exclusion amount in 2014 is $5,340,000.

C. Deceased Spousal Unused Exclusion Amount

1. Section 2010(c)(4) defines the deceased spousal unused exclusion amount as the lesser of (i) the basic exclusion amount, and (ii) the unused portion of the basic exclusion amount of the last deceased spouse of such surviving spouse.

2. Once transferred to the surviving spouse, the DSUE amount is not adjusted for inflation.

3. The statute limits the surviving spouse to use of the unused exclusion of his or her <u>last deceased spouse</u>. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the last deceased spouse's executor makes or fails to make a timely election.

D. Election

1. The surviving spouse may use the unused exclusion amount of a deceased spouse only if the executor of the deceased spouse timely files a Form 706 for the deceased spouse and elects to make that spouse's unused exclusion portable. IRC § 2010(c)(5); Temp. Reg. § 20.2010-2T(a)(2). The regulations make clear that the return must be filed by the nine month due date unless an extension request is timely made. Temp. Reg. §20.2010-2T(a)(1).

2. The last timely-filed return is determinative of whether the election is made and that election is irrevocable. The regulations do not currently provide a procedure for relief to make a late election. Nor do they provide a procedure for a protective election.

   a. Section 2010(c)(5) states "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for such return."

b. The Internal Revenue Code does not prescribe a time for filing a return for an estate that is below the threshold for filing an estate tax return, because there is no filing requirement. The regulations issued under Section 2010 fill this gap. Temp. Reg. § 20.2010-2T(a)(1).

c. Because the filing deadline for estates under the filing threshold arguably is imposed by the regulations, not statute, estates under the threshold should be able to apply for relief for a missed election under Treas. Reg. §301.9100-3. The IRS confirmed this interpretation in Rev. Proc. 2014-18 (issued January 27, 2014). Relief under § 301.9100-3 requires a private letter ruling request. Rev. Proc. 2014-18 provides a temporary simplified procedure for seeking relief. The relief is available only for estates of decedents who died after December 31, 2010 and before December 31, 2013. To obtain relief under the Revenue Procedure, the executor must file an estate tax return by December 31, 2014.

d. Letter Ruling 201407002 (Nov. 4, 2013) illustrates the use of § 301.9100-3 to obtain relief for a missed portability election. The decedent's estate was less than the basic exclusion amount, so the estate was not required to file an estate tax return under Code Section 6018. The estate failed to file the return in a timely manner to elect portability and now was asking for an extension of time to make the portability election. The IRS granted an extension of time to file the Form 706.

e. Similar relief is not available for an estate over the filing threshold. Of course, unless the taxpayer missed the filing of the Form 706 entirely, the only relief sought in most cases would be to elect out of portability. The filing of the return constitutes an election to make the DSUE amount portable.

3. The Act provides that, if the portability election is made, there is no statute of limitations for examining the predeceased spouse's Form 706. The waiver of the statute is limited to determining the amount of unused exemption available to the surviving spouse. IRC § 2010(c)(5)(B). Thus, if the normal statute of limitations under Code Section 6501 has expired, the IRS will not be able to adjust the deceased spouse's return and increase the tax due. It could, however, make adjustments to the return, such as by modifying the amount of adjusted taxable gifts, including additional assets or changing the valuation of certain assets, for the purpose of reducing the DSUE amount.

E. The Framework for Analysis of the Use of Portability

1. It is important to analyze portability in the context of the current tax environment and the non-tax factors that impact all estate planning.

2. The single biggest development impacting planning with portability, in fact all estate planning, is the increase in the applicable exclusion amount to $5,000,000 indexed.

   a. As a result of the $5,000,000 exclusion, a significant portion of the "millionaire population" that traditionally were subject to estate tax no longer have to worry about the tax.

   b. That portion will increase with the inflation adjustment to the exclusion. Many retired couples with medium sized estates eventually move into a consumption mode, where their inflation-adjusted, if not their real, net worth starts to go down. Meanwhile, the exclusion amount will increase, by $75,000 to $150,000 per year given current inflation rates.

   c. The following table shows the projected applicable exclusion amount at low, average and high inflation rates, starting with the 2014 base of $5,340,000

Year	1.5%	3%	5%
2014	5,340,000	5,340,000	5,340,000
2020	5,820,000	6,340,000	7,120,000
2025	6,240,000	7,330,000	9,070,000
2030	6,690,000	8,460,000	11,550,000

3. Combined with portability, the increasing applicable exclusion amount means that many married couples will stay safely under the threshold for paying federal estate tax.

4. The spread between estate tax rates and capital gains tax rates has dropped significantly. This clearly had changed the analysis in lifetime gift planning.

   EXAMPLE: Jason makes a gift of a $500,000 asset. His basis in the asset is $300,000. The asset appreciates to $800,000 by the time Jason dies in 2000. The $300,000 of appreciation escapes estate tax, saving $165,000 (55% of $300,000). However Jason's family receives the asset without a step-up in basis. The cost of the lost step-up is $100,000 (20% of $500,000 of unrealized gain).

EXAMPLE: Jason makes the same gift of the same asset and it is valued at $800,000 when he dies in 2013. The estate tax savings is $120,000 (40% of $300,000). The cost of the lost step-up in basis is $119,000 (23.8% of $500,000 of unrealized gain).

a. In the second example, ignoring issues of timing and opportunities to avoid the capital gain, the transaction is essentially a wash. When state taxes are considered, Jason's family could be worse off because of the gift. In California, for example, the combined estate tax rate is 40% but the combined capital gains tax rate for a taxpayer in the highest bracket is 37.1%. The cost of the lost step-up in basis for a California family is $185,500.

b. The differential between estate tax rates and income tax rates is less than 10% in 5 states, and between 10% and 15% in another 20 states. See Lee, Paul S., "Paradigm Shift: The ATRA-Math," presentation by Bernstein Global Wealth Management (2013).

5. For estate tax purposes, every asset will receive at least one basis step-up. Thus, the impact of capital gains tax is different than the impact in gift planning. Unrealized gain and sheltered appreciation are being measured over the same period, the time between the first death and the surviving spouse's death.

a. Since capital gains tax rates (23.8% top rate federal) still are not as high as estate tax rates (40%), some argue that estate tax reduction is still most important.

b. Of course, if the estates of the couple are less than twice the exclusion amount, and who do not live in a state with a death tax, the only tax to plan for is income tax.

c. Moreover, in some states, the gap is much narrower when state taxes are taken into account. In New York, the effective estate tax rate is 49.6% and the top LTCG rate is 36.5% In California, the estate tax rate is 40% and the top LTCG rate is 37.1%

6. The life expectancy of the surviving spouse will be a factor in the analysis of estate tax versus capital gains tax. Looking at the different mortality tables used by the IRS under Section 7520 and Treas. Reg. Section 1.401(a)(9), the life expectancy of the surviving spouse after the first spouse's death is 14.2 to 17 years at age 70, 8.4 to 10.2 years at age 80, and 4.4 to 5.5 years at age 90.

7. The nature and mix of the couple's assets also are a factor.

    a. Marketable securities may appreciate significantly after the first spouse's death, but if it is a managed portfolio, it is likely that some gain will be realized on a regular basis as part of the investment strategy.

    b. A concentrated stock position in one public stock is less likely to have regular turnover if the family has a close connection to the company. However, if it was the decedent who has insisted on retaining the stock, and a professional trustee is now involved, it is likely that the position will not be maintained.

    c. Commercial real estate, oil and gas interests, or timber interests actually may have a declining basis and may be subject in part to higher capital gains rates. Likewise, appreciated tangible personal property, such as artwork or collectibles, is subject to a higher capital gains tax rate (28%). Intellectual property rights such as copyrights or patents are usually subject to ordinary income tax rates during the life of the inventor.

    d. In larger estates, the special tax attributes of specific assets traditionally are dealt with during post-death funding. The trustee would allocate securities or other assets to the credit shelter trust, and assets that are potentially taxed at higher rates or which will have a lower basis to the marital bequest.

8. Throughout the analysis, it is important to keep paramount certain general estate planning principles.

    a. The estate plan must be a plan that will work well if death occurs the day after it was signed, but also must have sufficient flexibility to continue to function even as circumstances change.

    b. The client will be less inclined toward lifetime transfers of property than the estate planning attorney. Many clients will not part with control of, or access to, assets even when it makes complete sense to do so from a tax standpoint.

F. Advantages of Portability

1. <u>Simplicity</u>. As previously discussed, the main advantage of portability is simplicity. It allows a married couple to prepare a simple estate plan that leaves all property to the surviving spouse (in trust or outright),

while still preserving the deceased spouse's applicable exclusion amount.

a. This is an advantage in particular for couples whose combined estates are under the applicable exclusion amount. The couple also can avoid the administrative inconvenience of dividing assets between them, and retitling assets in order to preserve use of the exclusion amount.

b. Many couples whose estates are under twice the exclusion amount also will want to take advantage of this simplicity. There is the risk of losing the DSUE amount and incurring some estate tax if the surviving spouse remarries and the second spouse also predeceases him or her, but for many clients this risk is minimal.

2. Additional Basis Step-Up. The primary tax benefit of portability is that assets passing to the surviving spouse will receive another step-up in basis at the surviving spouse's death, something not available for assets in a credit shelter trust.

a. In estates of couples that clearly will be less than twice the applicable exclusion amount, assuming the DSUE amount is not lost due to the last deceased spouse rule, there is no competing tax benefit and the basis step-up is a clear advantage.

EXAMPLE: John and Janet each have estates of $3,000,000. If John dies and leaves his $3,000,000 in a credit shelter trust for Jane, the trust assets will not receive a step-up in basis at Jane's death. Assume the assets grow to $5,000,000 and there is $1,400,000 of unrealized gain. Instead, if John left the $3,000,000 directly to Janet, and his executor elected portability the assets would be included in Janet's estate. All unrealized gain on the assets would be eliminated at Jane's death, avoiding potential capital gains tax of over $330,000.

b. In estates that are near or above twice the applicable exclusion amount, there may be a trade-off of income tax savings versus estate tax savings.

3. Use With Depreciating Assets. If the decedent's estate contains assets that likely will depreciate in value, such as promissory notes with imbedded income in respect of a decedent ("IRD"), then passing those assets to the surviving spouse may be preferable to using them to fund

a credit shelter trust. If most of the decedent's estate consists of these assets, then portability may be a good option.

4. Retirement Accounts.

a. In many estates, a high proportion of the wealth is in retirement accounts. Because the assets are IRD, they will shrink by the income taxes incurred as distributed. In addition, the minimum distribution rules for retirement accounts are less favorable when the account is allocated to a trust. The account likely will need to be distributed more rapidly if allocated to a credit shelter trust.

b. The preferred disposition for many married couples is to leave retirement assets to the surviving spouse. In the past, a typical beneficiary designation named the spouse as primary beneficiary and the participant's revocable trust as contingent beneficiary. The spouse then could disclaim a portion of the retirement assets if they were needed to fund the credit shelter trust and the spouse and his or her advisors decided that increasing the funding was worth foregoing the income advantages of rollover by the spouse.

c. With portability, the surviving spouse can avoid the choice between maximizing estate tax benefits and maximizing income tax benefits.

EXAMPLE: John has a $5,000,000 estate, with $3,000,000 consisting of several rollover IRA accounts. John designates Janet as beneficiary of the IRA accounts. At his death in 2012, $2,000,000 passes to a credit shelter trust, and the remaining $3,000,000 of IRA accounts to Janet. John's executor elects portability for his $3,000,000 of unused exclusion. Janet dies with a separate estate of $6,000,000, including $2,500,000 remaining in the IRAs (a decrease due to minimum distributions and income tax on those distributions). She has applicable exclusion of $8,340,000 consisting of her $5,340,000 and $3,000,000 of DSUE amount from John.

5. Residence.

a. A residence, particularly the primary residence, is another asset that may represent a substantial portion of the couple's wealth but that is often a poor candidate for use to fund a credit shelter trust.

b. For example, the client may want to continue to take deductions generated by the real estate taxes and the home mortgage on her personal income tax return.

c. If there is a mortgage, there may not be any cash in the trust with which to make the mortgage payments, and asking the beneficiary to pay those expenses may raise issues about whether the beneficiary has become a grantor of the trust by making principal payments on the mortgage.

d. If the house is owned in part by the credit shelter trust and in part by the surviving spouse, keeping track of each payment and the allocation of every expense will be bothersome and can be expensive.

e. If it is necessary to transfer the home to one spouse or the other to be sure that spouse has sufficient assets to fund a credit shelter trust and the "wrong" one dies first, there is not any adjustment in the basis of the residence if the surviving spouse would like to sell the property.

f. Ownership of the house in a trust might impact the availability of the homestead exemption or other tax benefits.

G. Advantages of Credit Shelter Trust Planning

1. Shelter of Appreciation and Income. The DSUE amount is not indexed for inflation. A credit shelter trust creates the opportunity for future appreciation and income to increase the value of assets outside the estate.

EXAMPLE: Wife dies in 2013 with assets of $4,000,000, all of which are left to Husband. As Wife's executor, Husband elects portability and receives $5,250,000 of DSUE amount. Husband had $3,000,000 of assets of his own, so he has a total of $7,000,000 of assets and $10,500,000 of applicable exclusion amount. Husband invests half the assets in a new business. Ten years later it is worth $15,000,000. His other assets have appreciated to $5,000,000 so his total estate is $20,000,000. Assume that Husband's basic exclusion amount is now $7,000,000 due to inflation adjustments. With the DSUE amount, which is not inflation adjusted, he can shelter $12,250,000 from estate tax.

If Wife had created a credit shelter trust with her $4,000,000 and Husband had used those funds for the business investment, all $15,000,000 would be sheltered from estate tax.

a. The additional shelter of a credit shelter trust is not likely to be a significant issue where the clients' net worth is modest. However, with younger couples it is hard to predict what their wealth will be many years in the future.

b. In addition, one should not completely ignore the possibility that Congress could lower the applicable exclusion in the future. It would be unfortunate if a couple with an estate slightly under twice the exclusion amount decided to rely on portability and the survivor dies when the basic exclusion amount is back to $1,000,000.

2. <u>Generation-Skipping Tax Planning</u>. There is no portability of GST exemption. A couple who wants to maximize the amount of property held in long-term trusts for descendants will want to use credit shelter planning.

a. Assuming the decedent's remaining applicable exclusion amount is being transferred to the surviving spouse through a portability election, the only way the decedent can take advantage of her remaining GST exemption is to use a reverse QTIP trust. IRC § 2642(a)(3).

b. All of the income of the QTIP trust is required to be distributed, so the value of the assets in the trust may not increase as rapidly as in a trust that can accumulate income.

c. In addition, if the reverse QTIP is the only QTIP created in the estate of the first spouse to die, or if the regular QTIP trust is not large or has been depleted, or, in worst case, if the regular QTIP trust is not obligated to pay the estate tax due on the reverse QTIP trust, the estate tax due at the death of the surviving spouse might have to be paid from the GST tax exempt assets in the trust. This will clearly reduce the effectiveness of the GST exemption allocation.

3. <u>Impact of Remarriage</u>. A risk with portability is that the surviving spouse will lose some or all of the DSUE amount if he or she remarries

and the second spouse also predeceases him or her. In addition, DSUE amount is not cumulative. By contrast, the surviving spouse's remarriage does not impact the benefits of a credit shelter trust and the surviving spouse can accumulate multiple credit shelter trusts.

EXAMPLE: John has survived Janet and is now a beneficiary with his children of a credit shelter trust holding $3,000,000. He also has $2,000,000 of DSUE amount from Janet. John marries Mary. Mary also predeceases John and leaves her entire $5,340,000 estate to a trust for her family. John's DSUE amount becomes -0-. The credit shelter trust is unaffected.

EXAMPLE: Same facts as the preceding example except that Mary leaves her $5,340,000 to a credit shelter trust for John and his children. John and his children are now beneficiaries of two credit shelter trusts funded initially with $8,340,000.

4. Protective Benefits of a Trust. A trust of course provides all the spendthrift protections that are at the core of estate planning. The trust assets are insulated from claims of creditors, are more protected if the surviving spouse remarries, and are better protected from misuse or misappropriation by the children.

   a. A decedent can achieve the same protective benefits by creating a marital trust for the surviving spouse, who still can claim DSUE amount.

   b. Because a QTIP trust is always an option in the planning, portability should not be viewed as directly inimical to the use of trusts.

   c. A credit shelter trust can benefit both spouse and descendants, and does provide greater flexibility regarding use of the trust property.

5. Avoiding Potential Audit Issues.

   a. If the credit shelter trust is funded with non-publicly traded assets that are difficult to value, the family can avoid risk of audit with respect to those assets at the second death.

   b. The credit shelter trust also allows a family that owns a closely-held business to isolate voting control outside the estate, or divide a controlling interest so voting control does not end up in the hands of the surviving spouse.

EXAMPLE: John owns a business that continues to do well and increase in value. Several years ago, John recapitalized the business and created classes of voting stock and nonvoting stock. He transferred 20% of the voting stock to an irrevocable trust and 40% to Janet. Janet dies. Her estate plan leaves her voting stock to a credit shelter trust, of which John is trustee. At John's death, he is not considered to have voting control for estate tax purposes.

H. Considerations with Non-standard Families

1. Estate planners should be cautious about relying on portability for married couples where there are children from a prior marriage, or other non-standard family situations. The estate planning attorney needs to consider whether leaving an executor with discretion to use portability is even appropriate, and if it is, who the executor should be and how the estate tax burden should be allocated.

2. The problem with portability in non-standard families is that it allows the surviving spouse to use the DSUE amount personally, rather than for the beneficiaries of the first spouse to die. In effect, electing portability is like leaving assets outright to the spouse.

3. The temporary regulations provide that, for a testate decedent, only the executor can make the portability election. Temp. Reg. § 20.2010-2T(a)(6). In these situations, the executor probably should not be a beneficiary under the estate plan, and/or should be directed as to a portability election.

    a. For example, if the estate is not large enough to independently require the filing of an estate tax return, an executor who is a child of a prior marriage may choose not to incur the expense of filing an estate tax return solely to make the portability election for the second spouse.

    b. Rather than have the parties disagree over the need for a return, or over covering the cost of its preparation, it is better to have the estate plan direct whether an estate tax return should be filed to elect portability, and, if so, who is responsible for the cost of the preparation and filing.

4. Often, in a complex family structure where a client has children from a prior marriage, a QTIP trust is used for the surviving spouse, with the trust assets eventually passing to the client's descendants. However, when a QTIP trust is combined with portability, the client's estate plan may not operate as intended.

EXAMPLE: John marries Mary several years after his wife, Janet dies. John has three children from his marriage to Janet. John bequeaths most of his estate to a QTIP trust for Mary, remainder to his children. He names Mary as executor. Mary elects QTIP treatment for the trust and portability. She then makes gifts to her family using John's DSUE amount. Mary dies with an estate equal to her basic exclusion amount, which she also leaves to her family. The QTIP trust pays estate tax, and John's children receive no benefit from his exclusion amount.

a. Even if Mary did not make gifts to her family, assuming that her estate was large enough to absorb most of her applicable exclusion amount (including the DSUE amount), the QTIP trust would have to contribute to cover the taxes attributed to it, unless the estate plan waives reimbursement.

b. Code Section 2207A requires reimbursement on a marginal not proportionate basis. Thus, the QTIP trust could bear most or all of the estate tax at the second spouse's death, while the second spouse's personal assets are sheltered in part by the deceased spouse's DSUE amount.

5. In cases such as these, the more prudent course of action may be to use traditional credit shelter/marital deduction planning. If there is DSUE amount available, then estate plan should direct whether it will be used and how the tax burden on the QTIP trust is handled.

6. These issues also could be addressed in a prenuptial or postnuptial agreement. For example, the parties could agree to permit the surviving spouse to have the use of any DSUE amount of the first spouse to die in return for an agreement that the surviving spouse would waive the right of reimbursement for tax due as a result of the inclusion of the QTIP trust in the surviving spouse's estate (or at least for that portion of the QTIP trust equal to the DSUE amount).

I. Impact of State Estate Tax

1. States that have a separate death tax or state estate tax tied to the old federal state death tax credit have not enacted portability for state tax purposes. Delaware appears to be the one exception; it defines its exemption amount by reference to the applicable exclusion amount under Section 2010(c).

2. A couple will forego use of the sheltering benefit of the state exclusion at the first death if they are relying entirely on portability. This could result in more state estate tax at the second death.

EXAMPLE: John and Janet are Illinois residents. Illinois has a $4,000,000 exclusion amount. John has $6,000,000 of assets and Janet has $3,000,000 of assets. They want their estate plan to be as simple as possible. Pursuant to their estate plan, all of John's assets pass to Janet at his death in 2013. His executor elects portability and passes John's $5,250,000 DSUE amount to Janet. At Janet's death, assume her estate is $9,000,000. It is sheltered from federal estate tax by her $10,500,000 applicable exclusion amount. However, Janet's estate is subject to Illinois estate tax of $801,049.

Assume John's estate plan instead creates a $4,000,000 credit shelter trust, and leaves $2,000,000 outright to Janet. Janet elects portability for the remaining $1,250,000 of John's exclusion. At Janet's subsequent death, her estate consists of the $2,000,000 from John and her separate $3,000,000. This is sheltered by her applicable exclusion amount and she owes no federal estate taxes. Her Illinois taxable estate is $5,000,000. The Illinois estate tax at her death is $285,714.

3. By contrast, portability may provide a benefit in some estates by allowing the couple to avoid estate tax at the first death while still preserving the decedent's full exclusion amount.

   a. Before portability, a couple living in a state with a lower state estate tax threshold who are using a typical marital/nonmarital estate plan and who wanted to avoid all estate tax at the first death would use a formula that funds the credit shelter trust with the largest amount that can pass free of federal and estate state tax.

   b. In Illinois, the estate plan could allocate $4 million to the nonmarital trust. In New York or Minnesota, only $1 million would be allocated to the nonmarital trust. The remaining assets, if any, would pass to a marital trust or the spouse.

   c. In states with a state only QTIP election, a QTIP trust could be used to preserve the federal exclusion. In states that do not allow a state only QTIP, like New York, the couple had to either under-utilize the federal exclusion or pay New York estate tax at the first death (about $420,000 on an estate of $5,250,000).

   d. Couples now can rely on portability at least to the extent of amounts greater than the state estate tax threshold. They still may owe state estate tax at the survivor's death, but all other things being equal, it is best to defer payment. And, if the surviving spouse moves to North Carolina, Florida or one of the many other states with no state death tax, he or she will avoid state estate tax entirely.

4. The possibility of a change of residence is a factor to consider with all clients. Assume a couple is living in a state that does not impose a state estate tax and they rely on portability at the death of the first spouse to die. However, several years later, the surviving spouse moves nearer to grandchildren in a state that does impose an estate tax. The assets that could have been protected from state estate tax in a credit shelter trust established at the death of the first spouse to die will be subject to state estate tax at the death of the surviving spouse.

J. Flexibility Planning Options

In creating an estate plan that defers the decision on portability, there are three primary options to choose among:

1. Disclaimer plan. The estate plan leaves the assets of the first spouse to die outright or in a marital trust to the surviving spouse, but provides that if the surviving spouse disclaims, the assets will pass to a credit shelter trust. The credit shelter trust could be for the sole benefit of the surviving spouse or for spouse and descendants.

   a. The danger with this option is that the surviving spouse fails to disclaim, even when it would be advantageous to do so.

   b. The surviving spouse also could be disabled. An agent under a power of attorney, assuming he or she has the authority to disclaim on behalf of the spouse, may be reluctant to do so.

   c. The attorney also needs to make sure the spouse does not take actions post-mortem that constitute acceptance of the decedent's property.

2. Single Fund QTIP. The plan leaves all the assets to a QTIP trust for the surviving spouse. The executor for the deceased spouse then can choose to elect the marital deduction for the trust and rely on portability, or not to make the QTIP election for all or a portion of the trust.

   a. The trustee of the QTIP trust usually is given the power to sever the trust into elected and non-elected portions.

   b. This plan puts the decision in the hands of the executor, who may be best suited to make the decision. It allows for the decision to be made up to 15 months after the date of death, rather than nine months with a disclaimer.

c. Some practitioners have expressed concern that the QTIP option may not be available due to Rev. Proc. 2001-38, 2001-1 C.B. 1335, which allows a taxpayer to ask to treat a QTIP election as null and void if unnecessary to reduce estate tax. The service has indicated informally that it will not use Rev. Proc. 2001-38 against taxpayers.

3. Clayton QTIP. This option is an add-on to the single fund QTIP. In addition to the QTIP trust, the estate plan can contain provisions for a credit shelter trust. If there is a non-elected portion of the QTIP trust, the trustee can elect to allocate it to the credit shelter trust, thereby creating a trust for spouse and descendants.

a. This option is superior to the disclaimer approach in that the surviving spouse can retain powers of appointment over the credit shelter trust. He or she cannot do that in a credit shelter trust funded by a disclaimer.

b. The decision to make the non-elected portion of the QTIP should not be made by the surviving spouse. If the spouse is executor or trustee, there should be provisions to allow an independent co-fiduciary to make the decision.

4. Variations. There are any number variations on these options that can be implemented. For example, for a couple that wants the survivor to have the option of receiving the property outright, the plan could provide that the property passes to Marital Trust A, but if any portion not elected for marital deduction, it goes to the Family Trust up to the exemption, otherwise to Marital Trust B.

a. Marital Trust A is a normal QTIP marital trust, but says that 2 weeks after the estate tax return is filed, the assets are distributed to the surviving spouse. Marital Trust B is a normal QTIP marital trust.

b. All the property thus goes to a marital trust for the spouse that will pass outright 9-15 months later (after FET filed). If the survivor decides it is beneficial to use the estate tax exemption rather than relying on portability and to use the GST exemption, the QTIP election will not be made for part or all of Marital Trust A. The nonelected portion then flows into a standard A-B formula: to standard credit shelter trust up to the exemption and marital trust for the balance.

II. The 3.8% Net Investment Income Tax

A. Explanation of the Tax

1. The Health Care and Education Reconciliation Act of 2010 added Section 1411 to the Code, effective December 31, 2012. Section 1411 imposes a nondeductible 3.8% tax on the net investment income of certain individuals, estates and trusts with income above specified thresholds.

a. The thresholds are $250,000 for married filing jointly taxpayers, $125,000 for married filing separately and $200,000 for single filers.

b. The threshold for estates and trusts in 2014 is $12,150.

2. The additional tax raises the maximum combined federal rate for ordinary income to 43.4% and for qualified dividends and capital gains to 23.8%

3. The IRS released the final regulations under Code Section 1411 on November 26, 2013.

4. The tax must be taken into account in estimated tax payments.

5. The tax works as a separately computed tax regime (think AMT).

B. Net Investment Income.

1. There are three major categories of income, which are offset by various allowed deductions, to determine NII. A common theme of all three categories is that if an item of income is not treated as income for regular tax purposes, it will not be NII for surtax purposes. The income items are—

2. Category 1. Gross income from interest, dividends, annuities, royalties, and rent (but not including those items that are income derived in the ordinary course of a non-passive business, such as rents, discussed below).

a. Any of these items that are not in regular income are not in NII—for example, municipal bond interest income is not included in NII.

b. Rents are generally passive for purposes of the IRC §1411 tax. There is an exception for real estate professionals that devote 500 hours annually to working in the real estate business. Reg.

§ 1.1411-4(g)(7). Otherwise, taxpayers must meet two tests for rent to be excepted from being net investment income: (i) material participation and (ii) the rental income activity is a trade or business.

3. Category 2. Gross income that is from (1) a passive activity or (2) a trade or business of trading in financial instruments or commodities is NII. (Rents would generally be considered passive income, but they are included in Category 1.) To determine whether an activity is "passive," the passive activity loss rules of IRC §469 apply. This category includes business income if the taxpayer does not materially participate in the business. Passive loss carryovers apply for NII purposes to offset passive NII (even passive loss carryover from years prior to 2013 can offset passive NII income).

   a. Under the IRC § 469 passive loss rules, activities may be "grouped"; an individual's activities in several businesses that are grouped may rise to the level of being material participation, even though the individual would not meet the material participation for any separate activity. Regrouping is generally not permitted under IRC § 469, but a one-time regrouping is allowed (which will apply for both regular and surtax purposes) on the return for the first year the individual would be subject to the surtax. Reg. §1.469-11(b)(3)(iv).

   b. Working interests in oil and gas property are treated as active, not passive activities. This applies whether the taxpayer owns the working interest directly or in an entity—except that if the interest is owned in an entity that limits the liability of the taxpayer, the interest will be deemed to be a passive activity. §469(c)(3)(A).

4. Category 3. Net gain that is included in taxable income (this would include capital gains). Examples of gains that are not included in taxable income (and therefore are not NII) include gain that is excluded from gross income on the sale of a principal residence, Qualified Small Business Stock, ESOP stock, build-up in value of life insurance policies, and tax-free like-kind exchanges and tax-free exchanges of life insurance policies.

   a. Gain on the sale of business assets used in an active business is not included in NII. Gains attributable to goodwill in the sale of an active business's are not NII. (The 2012 proposed regulations include this statement about goodwill, Prop. Reg. § 1.1411-7(c)(5)(ii)(B); the final regulations do not specifically address goodwill.

b. Net gain includes "recapture" income that is often recognized on the sale of investment real estate. Reg. § 1.1411-4(d), Ex. 2.

c. Capital losses can offset gains (indeed, "net gain" is what is included as NII in Category 3), but capital losses can offset income in Categories 1 or 2 only up to $3,000 per year.

d. Gain from the sale of S corporation or partnership interests is subject to special rules designed to be taxpayer friendly. The seller can exclude from NII the amount of gain that would have been excluded from NII (*i.e.*, the gain attributable to active trade or business assets) if the entity had sold its assets immediately before the taxpayer's sale of its interest in the entity. IRC §1411(c)(4). The 2012 proposed regulations had a complicated 4-step process, but the final regulations withdrew the 2012 prior regulations and new proposed regulations were issued adopting commentators' suggestions to simplify the reporting process. Prop. Reg.§1.1411-7.

5. Excluded Income Items. Several types of income are specifically excluded from NII, including (i) distributions from IRAs and qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) income subject to self-employment tax. As discussed above, certain gains from the disposition of interests in partnerships and S corporations are excluded. The final regulations specifically address various other exclusions covered by non-recognition provisions (such as IRC §1031), income covered by various exclusion provisions (such as IRC § 103, or IRC §121), wages, compensation, unemployment compensation, Social Security benefits, and alimony.

6. "Maybe" items

a. PFICs with QEF elections and CFCs - One of the key differences for investors between the regular income tax and the NIIT is with respect to investments in Passive Foreign Investment Companies ("PFICs"), with Qualified Electing Fund ("QEF") elections in place, and Controlled Foreign Corporations (CFCs). QEF inclusions from a PFIC and Subpart F inclusions from a CFC are subject to the regular income tax when earned, even if the cash has not been distributed. Similarly, QEF /Subpart F inclusions of income from QEFs/CFCs are subject to NIIT when earned, if the QEF/CFC is held through a trader fund. However, the same QEF/Subpart F inclusions of income would not be subject to NIIT if the QEF/CFC is held through an investor fund or if it is held directly by an individual. Instead, the income would only be subject to NIIT at the time the cash is actually distributed. Consequently, investment in a QEF/CFC directly or through an investor fund can create a timing difference between the regular income tax and the NIIT. While this timing difference requires taxpayers to keep a separate set of records to track the basis and income inclusion for both regular and NIIT purposes, it also creates an opportunity to defer the 3.8% tax.

b. There is a conformity election (“G election”) that eliminates the timing differences between NIIT and regular income tax inclusions. Domestic pass-through entities are allowed to make a binding G election at the entity level. However, for the 2013 tax year only, pass-through entities are only able to make the G election if all of the partners consent. Many asset management funds did not get consent for the 2013 year and will be providing their investors with the information to make the decision at the individual level. In order for an investor to do this analysis, it must weigh the additional cost and burden of not making the G Election with the potential savings from NIIT deferral. The magnitude or materiality of the investment, as well as how frequently the CFC/QEF makes distributions, should all be factored into the decision. While this decision will need to be made by investors in a partnership that invest in PFICs and CFCs, it also provides a planning opportunity for individuals to start investing directly into offshore funds instead of through partnerships. The direct investment in an offshore fund would typically be deemed an investment in a PFIC and, absent a G Election, investors can get a deferral on 3.8 percent of the earnings in a PFIC that is not available if invested in a partnership and taxed at the time of income allocation. By investing directly in a PFIC that would otherwise be an investor fund, investors also get the benefit of expense deductions that would otherwise be disallowed. Further, there are state and local benefits to PFIC investing because it eliminates some of the limitations set on interest and investment deductions in certain states. It will be interesting to see if a trend develops toward US investors directly investing in offshore investor funds instead of the onshore funds for these reasons.

c. Notional principal contracts. Under the 2012 proposed regulations, Notional Principal Contract (“NPC”) or swap income is NII for trader funds but not for investor funds. Capital gain or loss from the sale of swaps is NII to both investor and trader funds. While the 2013 proposed regulations eliminate this disparate treatment for the most part, they are not effective until tax years beginning after December 31, 2013. This is important to taxpayers invested in investor funds that own swaps because they may opt to follow the 2012 proposed regulations for the 2013 tax year and not pay NII tax on any swap income, other than the capital gain (loss) on disposition.

7. Foreign tax credits. Another difference between regular taxable income and NII has to do with foreign taxes. Foreign taxes reduce NII only to the extent a taxpayer is using them as a deduction for regular income tax purposes, but not if the taxpayer is using them as a credit. While many comments were made requesting excess foreign tax credits to be used to offset NII tax liability, IRS did not change its position in the final regulations.

8. Deductions. The final regulations added a wide variety of deductions "properly allocable to such gross income or gain" that can be subtracted in determining the "net" investment income. Reg. §1.1411-4(f). For trusts, the final regulations added that trustee fees can be deducted for purposes of the surtax, and planning opportunities are available in allocating trustee fees against certain types of income (see below)

C. Business Income and Material Participation – Individuals**.** The non-passive trade or business income exception requires (1) that there be an activity that involves a trade or business (within the meaning of IRC §162) and (2) that it is a non-passive activity within the meaning of IRC §469, which requires material participation by the taxpayer. Reg. §1.1411-5(a-b). (There is no exception for business income from trading financial instruments or commodities, whether or not the activity is passive.) Thus, generally there must be *both* (1) a trade or business and (2) material participation by the taxpayer. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or business income (unless the real estate company is in the trade or business of leasing multiple similar real properties). Also, generally any interest, dividends, capital gains, etc. earned on investment assets held by the business will constitute NII, no matter how strong the business purpose is for holding the investment assets and no matter if there is material participation so that the business is an active activity. Reg. §1.1411-6.

1. The material participation requirements under the IRC §469 passive loss rules are used for determining whether an activity is passive for purposes of the exception from the surtax for business income. §1411(c)(2)(A). Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

2. Individuals can use one of seven tests (one of them being the 500-hour rule) to establish material participation to avoid passive income treatment. Reg. §1.469-5T(a). In addition, there is a separate exception for real estate professionals (if the taxpayer performs more than 750 hours in real property trades or businesses). IRC §469(c)(7)(B). The rules are not as clear regarding material participation by trusts or estates.

D. Business Income and Material Participation – Trusts and Estates. There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the IRC §469 or §1411 regulations. The IRC §1411 final regulations declined to provide any guidance regarding this issue, despite the fact that it is now of much greater importance than for just the passive activity loss rules. The Preamble to the final regulations points out that "the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date." The IRS requested comments, including "recommendations on the scope of any such guidance and on specific approaches to the issue." For a detailed discussion of the application of the non-passive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* TAX NOTES 785 (Aug. 19, 2013).

1. Regulations addressing passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not treated as individuals for this purpose (so, for example, the 500-hour rule does not apply), and that the real estate professional exception does not apply to trusts. (The Richard Dees article cites ECC 201244017, an emailed advice, stating the IRS Office of Chief Counsel view that the real estate professional exception applies to individuals and C corporations but not trusts.) The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of IRC §469, which states very simply: "Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, at 735.

2. In the *Mattie Carter* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer

maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included.

a. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee.

b. The court reasoned that measuring the trust's participation by reference only to the trustee "finds no support within the plain meaning of the statue. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none." The court observed that no regulations are on point, but "the absence of regulations and case law does not manufacture statutory ambiguity."

c. The court acknowledged that it had studied the "snippet of legislative history IRS supplied" (including the Senate Finance Committee Report) as well as a footnote in the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, at 242 n.33, but the opinion concludes that "the court only resorts to legislative history were the statutory language is unclear, … which, … is not the case here." *Mattie K. Carter Trust v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003).

3. Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

4. Private Letter ruling 201029014 reiterates the general IRS position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity's activities on a regular, continuous, and substantial basis. It did not mention the *Mattie K. Carter* case and did not address the issue of participation as a trustee rather than participation as an individual.

5. If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee.

a. The IRS questioned that strategy in Technical Advice Memorandum 201317010 (released April 26, 2013). The trust in that TAM had owned stock in an S corporation. The trust had a trustee and a "Special Trustee." The trustee "did not participate in the day-to-day operations of the relevant activities" of the company. The individual who was the Special Trustee was also the president of a qualified Subchapter S subsidiary of the S corporation. The trust instrument limited the Special Trustee's authority in selling or voting the S corporation stock.

b. The IRS concluded that the trust did not materially participate in the activities of the company for purposes of the IRC §469 passive loss rules. The ruling highlights two issues: (1) the Special Trustee's authority was limited to voting and selling the S corporation stock; and (2) the Special Trustee's activities as president were not in the role as fiduciary.

c. As to the first issue, the ruling concluded that time spent serving as Special Trustee voting the stock of the company or considering sales of stock would count for purposes of determining the trust's material participation in the business, but the "time spent performing those specific functions does not rise to the level of being 'regular, continuous, and substantial.'"

d. As to the second issue, the ruling stated in its recitation of facts that the individual serving as president and Special Trustee "is unable to differentiate time spent" as president, as Special Trustee, and as a shareholder. The ruling reasoned that under IRC §469 the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement, or else an owner would invariably be treated as materially participating because most businesses involve employees or agents.

e. The ruling concluded that the work of the individual serving as Special Trustee and president "was as an employee of Company Y and not in A's role as a fiduciary" of the trust and therefore "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company. TAM 201317010 creates a significant distinction in the treatment of individuals vs. trusts with respect to the "employee" issue.

f. For individual taxpayers, their activities as employees of a business will be considered for purposes of determining their material participation in the business. For trust taxpayers, the IRS position is that the activities of a trustee as an employee of the business cannot be considered to determine the trust's material participation in the business.

g. Comments to the proposed regulations under IRC §1411 by the American Bar Association Tax Section submitted on April 5, 2013 recommend that the IRS issue new proposed regulations regarding material participation for a trust or estate for purposes of IRC §1411. The Tax Section Comments propose that such regulations recognize material participation by an estate or trust under any of three tests, one of which is that "[t]he fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity."

6. In addition to recognizing actions through employees or contractors, material participation of a trust could be based on direct participation of the fiduciary, and in that context, the Tax Section Comments reason that any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation. In light of the paucity of authority, "it is difficult to establish a framework for material participation by a trust (or an estate)." Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 EST. PL. 3, at 9 (April 2013). Despite the *Mattie K. Carter* case, the IRS is continuing to press the issue and could issue a regulation adopting the position taken by the IRS in the private rulings. *Id*.

7. A new case before the Tax Court regarding the requirements for material participation by a trustee for purposes of the passive loss rules came out taxpayer favorable. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9. (March 27, 2014). This case involves other issues as well, but it is the first time that the Tax Court had addressed this issue and the case is quite significant with respect to this matter.

E. NIIT – Applicability to trusts and expense allocation.

1. The following approach is used to determine a trust's undistributed net investment income.

   a. Determine the trust's distributable net income (DNI) and the items of income that comprise its DNI

   b. Determine the items of income that comprise the trust's NII (including making subtractions as appropriate for items that are deductible in determining NII; expenses must generally be allocated between NII and non-NII items on a reasonable basis, such as proportionate to the amounts of gross income).

   c. Items of income that are deemed to be distributed under the normal DNI distributions rules (or under IRC §642 for charitable deductions) and that also are items of NII will be deemed to be distributed NII.

   d. NII that is so determined to be distributed is taxed as NII to the recipient beneficiaries (based on their individual threshold levels).

   e. NII that is not distributed is taxed at the trust level (with its very low threshold ($12,150 in 2014)).

2. <u>DNI Results Dictate the NII Distribution Amounts</u>**.** Items of income that **both** (i) are distributions of DNI under the normal DNI rules, and (ii) are items of NII, will be considered distributions of NII. An example in the regulations is helpful is illustrating how this works. Reg. §1.1411-3(e), Ex. 1 is summarized below.

   Assume a trust with the following income (and no expenses) makes a $10,000 distribution to Beneficiary A in 2013:

Dividends	$ 15,000
Taxable interest	$ 10,000
Capital gain	$ 5,000
IRA distribution	<u>$ 75,000</u>
Total	$105,000

   a. *DNI:* All of the income except capital gain is in DNI. (See Subparagraph 6 below regarding whether capital gain is included in DNI. For this example, assume that capital gains are not in DNI.) Therefore the DNI is $100,000.

b. *NII:* All of the income except the IRA distributions is in NII. Therefore, there is $30,000 of NII.

c. *Distributed DNI:* The $10,000 distribution is (10,000/100,000), or 10% of the DNI. Accordingly, 10% of each income item included in DNI is deemed distributed under the normal DNI rules. Therefore, A receives $1,500 of dividends, $1,000 of interest, and $7,500 of IRA proceeds.

d. *Distributed NII:* Only items that are distributed under the DNI rules will be deemed distributed under the NII rules, and only those items of DNI that are distributed that constitute NII will be treated as distributions of NII. While $7,500 of IRA proceeds are distributed under the DNI rules, they are not NII. So the only items of NII distributed are $1,500 of dividends and $1,000 of interest. (These items are NII of Beneficiary A. If Beneficiary A has other income that, combined with this income, results in A having adjusted gross income in excess of the individual threshold, A will be subject to the 3.8% tax.)

e. *Undistributed NII*: The remaining NII ($30,000-1,500-1,000=$27,500) is undistributed NII taxed to the trust.

f. *Trust Surtax*: The trust surtax is 3.8% times the lesser of (1) the AGI threshold ($105,000 [gross income]-10,000 [distribution]-11,950 [highest bracket threshold]) =$93,050), or (2) the undistributed NII ($27,500). The lesser amount is $27,500, so the surtax is 3.8% x $27,500 = $1,045.

g. The regulations contain another example that describes the similar calculation process with distributions to three separate beneficiaries and a charity. Reg. §1.1411-3(e)(5), Ex. 2.

3. <u>Impact of Charitable Distributions</u>**.** Charitable distributions that are deductible under IRC §642(c) will shift both regular taxable income and NII to the charity, where it will not be subject to either tax. Section 642(c) allows a charitable deduction for any amount of gross income (including gross income from prior years) that pursuant to the terms of the governing instrument is paid or permanently set aside during the tax year for a charitable purpose specified in IRC §170(c).

a. The trust agreement does not have to mandate distributions to charity; distributions of income to charities as discretionary permissible beneficiaries qualify for the IRC §642(c) deduction. *Old Colony Trust Company v. United States*, 301 U.S. 379 (1937).

b. A summary by Turney Berry, Stephanie Casteel and Martin describe the procedure for applying the IRC §642(c) deduction for purposes of the NII surtax. The starting point is the special rule in IRC §662(b) for characterizing income distributed to individual beneficiaries when a charitable contribution is made from the trust. Under that rule, the charitable contribution deduction is allocated proportionately among the classes of income entering into the computation of trust income before individual distributions are characterized. Consequently, the charitable distribution is treated as paid off the top, reducing DNI and the amount of taxable income in the various classes that individuals must report.

c. However, in the case of individual beneficiaries to whom income is required to be distributed currently, the character of their distributions is determined by disregarding the charitable contribution deduction "to the extent that it [the deduction] exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently." Treas. Reg. §1.662(b)-2. As a result, the §642(c) deduction does not affect the DNI computation and characterization for purposes of determining the items of income distributed under a mandatory provision to an individual beneficiary.

EXAMPLE: A trust provides that income, including accumulated income, may be distributed to A, an individual, and/or XYZ Charity. In the current tax year, the trust has $40,000 of taxable interest and $10,000 of tax exempt interest, and DNI of $50,000. The trustee distributes $50,000 to XYZ Charity and $10,000 to A. In determining the amount that A is required to take into income, the entire charitable contribution deduction is taken into account. Since the deduction equals DNI, A has no amount that is included in her gross income.

Assume the same facts, except that the trust is also required to make an income distribution to B of $30,000. For purposes of determining the character of the distribution to B, DNI is $30,000. The charitable contribution deduction only reduces DNI by $20,000, the difference between the total income of the trust ($50,000) and the amount required to be distributed ($30,000). The charitable contribution is allocated proportionately to the income items ($16,000 to taxable interest and $4,000 to tax-exempt interest). B's distribution is then characterized as $24,000 of taxable interest and $6,000 of tax-exempt interest. B receives no income tax benefit as a result of the charitable distribution. In determining the amount that is included in the gross income of A, however, the entire charitable contribution can still be taken into account, with the result that for A's purposes there is no DNI and therefore no amount that A has to take into income

d. Comparable rules apply for determining NII in the hands of individual beneficiaries. Prop. Reg. §1.1411-3(e)(4). In the examples above, A would have no NII as a result of the trust distribution; B would have $24,000 of NII, since the tax-exempt interest portion of her distribution would constitute excluded income. Berry, Casteel, Hall, Charitable Planning Today, 48TH ANN. HECKERLING INST. ON EST. PL., AT IV-A-115 (2014).

e. The final regulations contain a detailed example that includes distributions to individuals and distributions to a charity that are deductible under §642. Reg. §1.1411-3(e)(5), Ex. 2.

4. <u>Allocation and Deduction of Expenses</u>**.** Expenses are first allocated directly to the income item that gave rise to the expense. For example, expenses attributable to rental property must be allocated against rental income. For indirect expenses, however, the regulations under IRC §652 allow the fiduciary to allocate them any way desired (except that they must be allocated proportionately to tax-exempt income [for which the taxpayer receives no benefit]). Accordingly, indirect expenses can be allocated against income that would otherwise be subject to the highest rate. (Tax preparation software will not do this typically. The preparer will need to override the software output to make such special allocations of indirect expenses.)

5. <u>Approach for Calculating NII Distribution With Allocated Expenses</u>.

a. Expenses that are not directly attributed to an income item may be deducted against any item(s) of DNI. That will impact which of those items that also happen to be NII that may possibly be treated as distributed.

b. Separately, the expenses must be allocated between NII and non-NII items in a reasonable manner (generally based on the relative amounts of gross income).

c. Distributed NII is the lesser of the amounts of NII from Step 2 that are also deemed distributed under Step (1). (Unfortunately, there are no examples in the regulations for determining NII that is distributed, taking into consideration the deductions of expenses properly allocable to NII.)

EXAMPLE*:* Assume the following:

IRA distribution (in DNI, not in NII)	$20,000
Capital gain (not in DNI, in NII)	$20,000
Taxable interest (in both DNI and NII)	$20,000
Trustee fees	$10,000
Discretionary distribution to A	$10,000

Trustee fee allocation: The trustee fee is allocated to the IRA distribution (which is in DNI but happens to be non-NII); this should result in more NII assets being deemed distributed.

DNI: After subtracting the $10,000 trustee fee from the IRA distribution, the DNI is:

IRA net after deduction	$10,000
Interest	$20,000
TOTAL	$30,000

Distributed DNI: The $10,000 distribution is (10,000/30,000), or 33.3% of the DNI. 33% of each income item included in DNI is deemed distributed under the normal DNI rules. Therefore, A receives $3,333 of IRA proceeds, and $6,667 of interest.

NII, after subtracting deductible expenses: The $10,000 trustee fee must be allocated between the NII items (capital gain and interest-total gross income of $40,000) and non-NII item (IRA-gross income of $20,000). Therefore, 2/3 (40,000/60,000) of the $10,000 trustee fee is allocated against the $40,000 of NII items, leaving $40,000 – 6,667 = 33,333 of

NII items after the deductions. The regulations are not clear as to how the expenses must be allocated among just the NII items; conceivably they must be allocated on a gross income pro rata approach as well, meaning that the trustee fee is allocated on a pro rata gross income basis among all items of income merely for purposes of determining the "net" income (after deductions) of each item of NII. This means that the $10,000 of trustee fees is allocated $3,000 to the IRA (non-NII), $3,333 to the capital gain, and $3,333 to the interest. Therefore, the NII items, after subtracting allocable deductions on a gross income-pro rata basis of all gross income are:

Capital gain	$20,000 - $3,333 = $16,667
Interest	$20,000 - $3,333 = $16,667

Distributed NII: There is $16,667 of capital gain after deduction of allocable expenses, but it was not deemed distributed under the DNI rules so it is not distributed NII. There is $16,667 of interest after deduction of allocable expenses, and there is $6,667 of interest in DNI that is deemed distributed. Therefore, $6,667 of NII is distributed, leaving $26,667 of NIII after allocable expenses that is not distributed ($16,667 of capital gain and [$16,667 – 6,667, or $10,000] of interest).

d. Observation - Only one type of NII in DNI. In this most simplified example, only one type of NII is also in DNI (the interest). If there had also been dividends, which for regular tax purposes would be taxed at a lower rate than the interest, the trustee would also have to take into consideration the effect of different tax rates applicable to the various classes of income.

6. Capital Gains in DNI. Capital gains are an item of net investment income. While distributions reduce both AGI and net investment income, capital gains cannot be distributed without authority in the trust instrument or state law for doing so. Trust instruments can either mandate how distributions are allocated against various types of taxable income, or can give the trustee discretion to allocate capital gains to income that is distributed. For an excellent discussion of various alternatives see Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32, 35-37 (Dec. 2012).

a. Capital gains ordinarily are excluded from DNI. Reg. §1.643(a)-3(a). However, the regulations provide the capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)":

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. Reg. §1.643(a)-3(b).

b. Planning possibilities using each of these three exceptions are summarized below.

(1) *Exception (1)*. One possible approach is to provide in the trust agreement that capital gain is allocated to income (except for mandatory income trusts—so that the capital gains would not have to be distributed). If the distribution standard allows discretionary distributions of income or principal to all of the current beneficiaries, this would not seem to have any economic impact. The "consistently exercised" requirement does not apply under the § 1.643(a)-3(b)(1) regulation in which gain is allocated to income if there is no unitrust provision. Example 4 of Reg. §1.643(a)-3(e) confirms this result.

(2) *Income From Flow-Through Entities.* Another possible approach is to hold assets in a partnership or LLC. Under most state laws, distributions from the entity will be treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. The entity may have capital gains that will

be reported out to the partners or owners; the entity may make distributions, but those distributions will be fiduciary accounting income—so the capital gains would be included in DNI. This planning is based on a special rule for capital gains from pass-through entities that is helpful in carrying out capital gains to beneficiaries. Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States*, 34 Fed. Cl. 112 (1995); *see* Carol Cantrell, *Income Tax Problems When the Estate of Trust is a Partner,* ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1375, 1446-47 (April 2013). Furthermore, under the Uniform Principal and Income Act (UPAIA) cash distributions from an entity are generally allocated to fiduciary accounting income unless one of several exceptions applies (the primary exception being if cash is distributed in total or partial liquidation of the entity). Therefore, under UPAIA cash distributions from a flow-through entity with capital gains that are reported to the trust are treated as being allocated to income and meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.)

(3) *Exception (2).* Another approach is to give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a “deeming” rule. Example (1) of Reg. §1.643(a)-3(e) refers to a trust in which the trustee “is given discretionary powers to invade principal for A’s benefit and to deem discretionary distributions to be made from capital gains realized during the year.” In that example, “Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gains tax to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.” In Example (2)

the trustee elects "to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year," and in Example (3) the trustee "intends to follow a regular practice of treating discretionary distributions of principal is being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of assets." In each example, this treatment of capital gains is "a reasonable exercise of Trustee's discretion." In Examples (2) and (3) capital gains are included in DNI.

Trust agreements may specifically grant the trustee to allocate all or part of realized gains from the sale or exchange of trust assets to income or to principal (within the meaning of Reg. §1.643-3(b)), or to deem any discretionary distribution of principal as being made from capital gains realized during the year (within the meaning of Reg. §1.643(a)-3(e)). See generally Blattmachr & Gans, *The Final "Income" Regulations: Their Meaning and Importance,* 103 TAX NOTES 891 (2004).

(4) The "treated consistently" requirement applies to exception (2) (*i.e.*, capital gain that is allocated to corpus but treated as part of a distribution). This is easy to meet if the issue arises in the trust's first year or perhaps if the §1411 final regulations allow a fresh start in light of the significant tax law changes in ATRA. Otherwise, how a trust changes its position to start deeming that capital gains are included in distributions is not clear. (Historically, capital gains typically have not been treated by trustees as being included in distributions to cause them to be included in DNI.)

(5) *Exception (3).* Some commentators suggest that an allocation of capital gains to corpus under Reg. §1.643(a)-3(b)(3) when "utilized by the fiduciary in determining the amount that is to be distributed" does not have to be exercised consistently from year to year. One commentator acknowledges that the IRS has not provided further guidance regarding the meaning of revised subsection (b)(3), but that subsection (b)(3) "should be applicable when the fiduciary varies the amount of a principal distribution based upon the

amount of the trust's or estate's capital gains for the year," and suggests, as a practical matter, that a trustee allocating capital gains to principal under subsection (b)(3) "make a record, before the distribution if possible, of the decision to do so." Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA*, TRUSTS & ESTATES 23 (March 2013). As an example, a trustee may study the trust income and income tax brackets of the trust and beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been "utilized by the fiduciary in determining the amount that is distributed" thus satisfying exception (3). This rationale extends beyond the examples in the regulations for exception (3). Those examples include: (i) a trust that is directed to hold an assets for 10 years and then sell it and distribute the proceeds (Ex.6); (ii) amounts distributed in a year the trust terminates when all income and principal is required to be distributed (Ex.7), and (iii) a trust requiring that one-half of the principal be distributed at a particular age, at which time the trustee sells one-half the securities and distributes the proceeds (Ex.9). However, the suggested scenario seems to meet the literal requirements stated in exception (3) because the capital gains have been "utilized by the fiduciary in determining the amount that is distributed."

7. Distributions. Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. See Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32 (Dec. 2012). Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket ($450,000/$400,000 in 2013, $457,600/$406,750 in 2014). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the $250,000/$200,000 threshold. The total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

    a. In making decisions about the tax impact of distributions, keep in mind that if the trust is in a state that does not have a state income tax on the trust, making the distribution to a beneficiary who lives in a state with a state income tax may generate enough state income tax to the beneficiary to more than offset the federal income tax savings to the trust by making the distribution.

b. This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. *Drafting Tip:* Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

c. These additional income tax implications may also factor into the trustee's investment decisions—for example, whether to include allocation to tax-exempt investments.

III. Final Regulations Under Code Section 67(e)

A. Background

1. Before any IRS guidance on the treatment of IRC §67 deductions in a trust or estate, there were a couple U.S. court of Appeals that ruled on this issue – both with differing outcomes. The 6th circuit ruled that investment advisory fees fully deductible. The 4th circuit ruled that investment advisory fees are subject to 2% limitation.

2. In July 2007, regulations were proposed under section 67(e) to clarify which costs are unique to an estate or a non-grantor trust and are therefore not subject to the 2% floor for miscellaneous itemized deductions. The 2007 proposed regulations included a nonexclusive list of services or products for which the costs would be unique (and therefore fully deductible such as fiduciary fees) and, conversely, a nonexclusive list of services or products (including investment advisory fees) that would be subject to the 2% floor.

3. In early 2008, the U.S. Supreme Court held that fees paid to an investment advisor by a non-grantor trust or estate generally are subject to the 2% floor for miscellaneous itemized deductions under

section 67(a)— *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181 (2008).

4. The Supreme Court held that the proper reading of the language in section 67(e)—which asks whether the expense "would not have been incurred if the property were not held in such trust or estate"—requires an inquiry into whether a hypothetical individual who held the same property outside of a trust "customarily" or "commonly" would incur such expenses. Thus, expenses that are "customarily" or "commonly" incurred by individuals would be subject to the 2% floor.

5. Following the Supreme Court's decision in *Knight*, the IRS issued Notice 2008-32 as interim guidance on the treatment of "bundled fiduciary fees." Notice 2008-32 and then subsequent notices eventually provided that taxpayers are not required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor under section 67 for any tax year beginning before before the publication of final regulations in the *Federal Register*.

6. In September 2011, Treasury and the IRS released proposed regulations. In those regulations, the IRS and Treasury found that the Supreme Court in *Knight* had held that the deductibility of an expense under section 67(e)(1) depends upon whether the cost is "commonly" or "customarily" incurred when the property is held instead by an individual. In other words, as the Court restated its holding, section 67(e)(1) excepts from the 2% floor "…only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual..." holding the same property to incur (emphasis in original).

7. In applying this interpretation to investment advisory fees incurred by a trust, the 2011 proposed regulations explained that the Supreme Court found that such fees generally are not uncommonly incurred by individual investors and thus are subject to the 2% floor.

B. Commentary on final vs. proposed regulations found in the preamble to the final regulations:

1. The final regulations were issued in May of 2014 and are very similar (with only a few minor modifications) to the proposed regulations. The regulations provide that a bundled fee (generally, a fee for both costs that are subject to the 2-percent floor and costs that are not) must be allocated between those two categories of costs. However, the regulations provide an exception to this allocation requirement for a bundled fee that is not computed on an hourly basis. Specifically, for such a fee, only the portion attributable to investment advice

(including any related services that would be provided to any individual investor as part of the investment advisory fee) will be subject to the 2-percent floor. Notwithstanding this exception, payments made to third parties out of the bundled fee that would have been subject to the 2-percent floor if they had been paid directly by the estate or nongrantor trust, and any payments for expenses separately assessed by the fiduciary or other service provider that are commonly or customarily incurred by an individual owner of such property will be subject to the 2-percent floor.

2. The proposed regulations contained an example to illustrate a type of expense that is separately assessed: an additional fee charged by the fiduciary for managing rental real estate owned by the estate or non-grantor trust. Several commentators correctly noted that the expense in this example is not a miscellaneous itemized deduction, but is instead fully deductible. See sections 62(a)(4), 212, and 611. Therefore, the final regulations delete this example.

3. Most commentators objected to the requirement that a fiduciary commission be unbundled. They recommended that a single fiduciary commission that is not computed on an hourly basis, or otherwise separately stated, be entirely exempt from the 2-percent floor. The primary reason that commentators gave for this recommendation is the administrative difficulty and burden of the required calculations and recordkeeping. At least one commentator, however, acknowledged that unbundling a fiduciary commission is appropriate to provide the same tax treatment to the same expenses, regardless of how those expenses are billed.

4. Commentators also challenged the regulatory authority to require this unbundling, arguing that there is no statutory ambiguity with regard to a fiduciary commission and thus no authority to apply the 2-percent floor to any portion of that commission. The Treasury Department and IRS believe the authority to unbundle rests with the authority to define expenses that "would not have been incurred if the property were not held in such trust or estate."

5. Consistent with the Knight decision, the final regulations interpret this statutory exception to the 2-percent floor to capture those expenses that would not commonly or customarily be incurred by an individual. In identifying these expenses, the Court in Knight specifically recognized that unbundling may be required in the case of investment advisory fees, the costs of which exceed the costs charged to an individual investor and which are incurred either because the investment advice is being rendered to a fiduciary or because of an unusual investment objective or the need for a specialized balancing of

interests of various parties. The final regulations adopt this reasoning and, consistent with the Knight decision, provide that the portion of such a fee in excess of what would have been charged to an individual investor may be exempt from the 2-percent floor. Based upon the Knight decision and the authority to promulgate interpretative regulations, the Treasury Department and IRS believe that the final regulations are within the scope of regulatory authority.

6. The Treasury Department and IRS also believe that retaining the unbundling requirement in the final regulations is appropriate because it provides equitable tax treatment to similarly situated taxpayers. Taxpayers that pay investment fees to a third-party investment advisor and those that pay investment fees as part of a bundled fee should receive similar tax treatment. The Treasury Department and IRS also believe that the limitations to the unbundling requirement reduce administrative burdens. For example, a fiduciary fee, an attorney's fee, or an accountant's fee that is not computed on an hourly basis is fully deductible except for (i) amounts allocable to investment advice; (ii) amounts paid out of the bundled fee by the fiduciary to third parties if those amounts would have been subject to the 2-percent floor if they had been paid directly by the non-grantor estate or trust; and (iii) amounts that are separately assessed (in addition to the usual or basic fiduciary fee or commission) by the fiduciary or other service provider that are commonly or customarily incurred by an individual owner of such property. Because the latter two categories relate to amounts that are traceable to separate payments, the Treasury Department and IRS believe that the administrative burden associated with subjecting these amounts to the 2-percent floor is insubstantial.

7. Furthermore, where amounts are allocable to investment advice but are not traceable to separate payments, the final regulations retain the flexibility of allowing the use of any reasonable method to make the allocation to investment advice. The Treasury Department and the IRS believe that the availability of any reasonable method mitigates administrative burden. However, to provide additional guidance, these final regulations provide non-exclusive factors to further reduce administrative burden for both taxpayers and the IRS. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on the types of methods for making a reasonable allocation to investment advice, including possible factors on which a reasonable allocation is most likely to be based, and on the related substantiation needed to satisfy the reasonable method standard. The Treasury Department and the IRS received only one comment in response to this request, which explained that there is no single standard that could be applied to multiple trusts or even to the same trust in different years.

8. In finalizing these regulations, the Treasury Department and the IRS reconsidered comments received in response to Notice 2008-32. Although some comments supported a percentage safe harbor, the percentages suggested assumed that all fees that are customarily incurred by individuals (and not just investment advisory fees) would be required to be unbundled. For this reason, the percentages that were suggested are not readily applied to the framework of the final regulations. The final regulations, however, permit the Treasury Department and the IRS to provide safe harbors in future published guidance.

C. The final regulations, provide specific examples of costs subject and not subject to the 2% floor.

1. The following costs would be subject to the 2% floor:

- Costs that are commonly or customarily incurred by a hypothetical individual owning the same property
- Costs incurred merely because the trust or estate is the owner of an asset (including partnership costs passed through on a Schedule K-1)
- Investment advisory fees are generally subject to the 2% floor except to the extent the fee exceeds the fee generally charged to an individual investor and such excess is attributable to some identifiable aspect of the service unique to the trust or estate

2. Conversely, the following costs would not be subject to the 2% floor:

- Tax return preparation costs for estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax return, but all other tax returns including gift tax returns are subject to the 2% floor
- Appraisal costs for determining date of death value, for valuation of distributions, or as otherwise required for preparing the estate's or trust's tax returns
- Certain fiduciary expenses such as probate fees, fiduciary bond premiums, legal publication costs, costs of certified copies of death certificates, and costs related to fiduciary accounts

D. Bundled fees that are charged by a trustee or executor on an hourly basis must be allocated between those services subject to the 2% floor and those that are not. For bundled fees that are charged other than on an hourly basis, "only that portion of that fee that is attributable to investment advice is subject to the 2% floor." The final regulations provide that any reasonable method may be used to allocate such a bundled fee. Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to: the percentage of the value of the corpus subject to investment advice; whether a third-party advisor would have charged a comparable fee for similar advisory services; and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

E. Out-of-pocket expenses billed separately from the bundled fee are considered a separate cost subject to its own analysis. Charges paid to third parties from the bundled fee that would have been subject to the 2% floor had they been paid directly from trust or estate funds must be separated from the bundled fee and are subject to the 2% floor. And, finally, separate fees levied by the executor or trustee in addition to the normal bundled fee are treated as separate costs subject to their own analysis.

IV. Hot Button Issues in Estate and Gift Tax Audits

A. Estate of Wimmer v. Commissioner, T.C. Memo 2012-157

1. In Wimmer, the court bucked the trend of recent cases and concluded that gifts of limited partnership interests met the requirements for present interests and qualified for the gift tax annual exclusion.

2. George and Ilse Wimmer created a limited partnership which restricted the transfer of the partnership interests and limited the instances in which a transferee could become a substitute limited partner. The transfer of limited partnership interests required the prior written consent of the general partners and seventy percent in interest of the limited partners. A transferee would not become a substitute limited partner until several requirements were met, including being accepted as a substitute limited partner by the unanimous written consent of the general partners and the limited partners.

3. There was an exception for the transfer of partnership interests by gift or as the result of a partner's death if the transfers were to or for the benefit of an incumbent partner or any related party. Related parties were descendants and ancestors of a partner or an estate or trust, the sole beneficiaries of which were descendants or ancestors of a partner.

4. The taxpayers made transfers to irrevocable trusts for grandchildren and other relatives, using Crummey powers. The assets of the partnership consisted primarily of publicly traded dividend paying stock.

5. In prior cases, such as Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003), Price v. Commissioner, T.C. Memo 2012, and Fisher v. United

States, 105 A.F.T.R. 2d 2010-1347 (S. D. Ind. 2010), the courts held that gifts of limited partnership or limited liability company interests were not present interests, because of various restrictions on them.

6. Here the court did not focus on the transfer restrictions but on whether rights to income satisfied the criteria for a present interest. It put forth a three part test, based upon Calder v. Commissioner, 85 T.C. 713 (1985). Under this three prong test, the taxpayer would have to prove that:

   a. The partnership would generate income;

   b. Some portion of that income would flow steadily to the donee; and

   c. That portion of the income flowing to the donee could be readily ascertained.

7. The court focused on the facts that the partnership consisted of marketable securities that would generate regular income and that it would be necessary for the general partners to distribute some income to satisfy the annual federal income tax liabilities of the partners, one of which was a trust with no other assets. The necessity of a partnership distribution in these circumstances was within the purview of the fiduciary duties imposed on the general partners. As a result, the gifts of the limited partnership interest qualified as present interests.

B. Estate of Richmond v. Comm'r, T.C. Memo 2014-26

1. On her death, Helen owned a 23.44% interest in Pearson Holding Company (PHC), a family owned company which owned primarily publicly traded stock. The stated purpose of PHC was to preserve capital and maximize dividend income. When preparing the Form 706, Helen's estate relied on a draft valuation report prepared by an accountant. Using the capitalization of dividends method, the accountant valued Helen's stock at $3,149,767.

2. The IRS issued a notice of deficiency, valuing the stock at more than $9 million. The estate filed a petition with the Tax Court, but the expert for the estate conceded that the value of the stock exceeded what had been declared on the return. He valued the stock using the same capitalization of dividends method, this time arriving at a value of approximately $5.046 million and, alternatively, by using the net asset value method, concluding a value of about $4.721 million.

3. First, the Court held that the stock should be valued using the net asset value method. It explained that the net asset value approach is more appropriate because the assets of PHC were easily-valued public stocks. According to the Court, the capitalization of dividends method introduced too many uncertainties about general future economic performance that were unnecessary in this instance.

4. Next, the Court agreed that the built-in capital gains attributable to the company's stock holdings (estimated to be approximately $18 million) needed to be taken into account, but held that the estate was not entitled to a dollar for dollar discount for the tax liability. Instead, the tax liability should be discounted to its present value based on a reasonable holding period. When the Court calculated the present values using a few holding periods and discount rates, it found that the IRS discount of $7.8 million was reasonable, and upheld the IRS discount. The Court acknowledged that other Circuits (notably the 11^{th} and 5^{th}) have determined that a dollar for dollar discount is appropriate. However, it reasoned that in a case where a hypothetical buyer of an interest in the company would probably retain the stock held in the company for at least some time, it was not likely that the capital gains would be triggered immediately and therefor a dollar for dollar discount was inappropriate.

5. The Court also approved a minority discount of 7.75% and a lack of marketability discount of 32.1%. In the end, after discounting the net asset value of the company for the built in capital gains and discounting the interest for its lack of control and marketability, the Court determined the value of Helen's interest was $6.503 million. Since the value reported on the estate tax return was less than 65% of the value determined by the court, the estate was subject to accuracy-related penalties unless it could prove that it acted with reasonable cause and good faith. The Court was not convinced by the estate's arguments on this point and held that using an unsigned draft report of an accountant who was not a certified appraiser did not qualify as reasonable cause or good faith. The fact that the estate itself adjusted the value of the interest with a new expert without explaining the accountant's valuation on the Form 706 was particularly hard to overcome.

C. <u>Estate of Kite v. Commissioner</u>, T.C. Memo 2013-43

1. The court ruled that the transfer of partnership interests to the decedent's children in exchange for a private annuity was not a disguised gift, but that the transfer of assets in two QTIP trusts in

connection with termination of those trusts constituted a taxable gift of the remainder interests under Section 2519

2. The decedent, Virginia Kite, was the income beneficiary of two qualified terminable interest property (QTIP) marital deduction trusts, one life estate/power of appointment marital deduction trust, and one revocable trust. In 2001, the QTIP trusts and the life estate/power of appointment marital deduction trust were liquidated and the trust assets, which consisted entirely of family partnership interests, were transferred to Mrs. Kite's revocable trust. The family partnership interests held by the revocable trust were then transferred to Mrs. Kite's children in exchange for 10-year deferred private annuities. After Mrs. Kite's death, the IRS issued notices of deficiency of $6,573,752 in federal gift tax and $5,100,493 in federal estate tax. The IRS challenged both the validity of the private annuity transactions and the tax effect of termination of the marital trusts.

3. The first issue reviewed by the court was whether the transfer of the partnership assets in exchange for a private annuity was a gift or a sale. Mrs. Kite, as trustee of her revocable trust, sold her interests in the family limited partnership to her children for three private annuity agreements with the first payments deferred for 10 years. Mrs. Kite agreed to the terms of the annuity transaction after consulting with her children, the family lawyer, and her trust officer and after being assured that she could continue to maintain her lifestyle without the income from the family limited partnership interests. Mrs. Kite also consulted her physician who sent a letter attesting to her longevity and good health. The parties valued the annuity agreements under the Section 7520 regulations and actuarial tables. The children did not make any annuity payments to Mrs. Kite before she died in 2004. The court determined "based on unique circumstances of this case and, in particular, Mrs. Kite's position of independent wealth and sophisticated business acumen, that the annuity transaction was a bona-fide sale for full and adequate consideration and not a gift."

4. The next issue was whether the liquidation of the two QTIP trusts before the private annuity transaction was a gift under Section 2519. Two days prior to entering into the private annuity agreement, the Kite children, who had immediately prior to this replaced their mother as the trustees of the two QTIP trusts, terminated the QTIP trusts and transferred the family limited partnership interests in the trusts to Mrs. Kite's revocable trust.

    a. In previous cases, the IRS had tried to invalidate such transfers on the grounds that they exceeded the distribution standards under the trust. Here, the Service treated the distribution in termination of the trusts followed immediately by the private annuity transaction as a disposition of the qualifying income interest for life and a taxable gift under Section 2519.

b. The court found that the sale of Mrs. Kite's interests in the family limited partnership which could be traced to the QTIP trust was subject to gift tax under Section 2519 to the extent of the fair market value of the entire property subject to Mrs. Kite's qualifying income interest less the value of her income interest. Because Mrs. Kite received adequate and full consideration for her income interest in the family limited partnership, she did not make a gift of her qualifying income interest under Section 2511.

5. The IRS also tried to apply the gift theory to the remainder beneficiaries with the termination of the life estate/power of appointment marital trust. The court found that the transfer of the trust assets to Mrs. Kite's revocable trust was not a transfer of property for gift purposes because Mrs. Kite did not transfer an interest in the property to another. Thus, the court applied a step transaction theory to the QTIP trusts to invoke Section 2519, but not to the power of appointment marital trust.

D. Chief Counsel Advisory 20130033 (July 26, 2013)

1. In this Advisory Opinion, the Chief Counsel found that a gift occurred when stock was sold to a grantor trust for a self-cancelling installment note and that the value of self-cancelling installment note should be included in seller's estate. The matter is now docketed in the Tax Court as <u>Estate of Davidson v. Comm'r</u>, Tax Court Docket No. 13748-13 (filed June 14, 2013)

2. Prior to his death, the decedent had created a series of grantor trusts for the benefit of family members, and then sold stock in a closely held corporation to the grantor trusts. In some of the sales, the decedent received a regular promissory note. In other sales, the decedent received a self-cancelling installment note.

3. Shortly after these transactions, the decedent was diagnosed with what turned out to be a fatal disease and survived less than six months. The Chief Counsel was asked for advice on three issues involving the self-cancelling installment notes.

a. Does any portion of the transfers of stock from the decedent to the grantor trust in exchange for the self-cancelling notes constitute a gift?

b. How should the fair market value of the self-cancelling installment notes be determined?

c. If the transfers do not constitute a gift, what are the estate tax consequences of the cancellation of the notes upon the decedent's death.

4. With respect to the first two issues, the Chief Counsel noted that the exchange of property for promissory notes will not be treated as a gift if the value of the property transferred is substantially equal to the value of the notes. The Chief Counsel then distinguished the current situation from Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003), where the court found the taxpayer had rebutted the presumption that an inter-family sale for a self-cancelling installment note is gratuitous.

5. In this situation, unlike Constanza, the Chief Counsel noted that the decedent structured the note so that the payments consisted of only interest with a large balloon payment of principal on the last day of the note. It said that this indicated that a steady stream of income was not contemplated. In addition, because the decedent had substantial assets and did not require the income to cover his daily expenses, this showed that the arrangement was nothing more than an estate planning technique to transfer stock to family members at less than fair market value.

6. The Chief Counsel also noted that the value of the notes was based upon the Section 7520 valuation tables, with a higher interest rate charged to account for the higher risk that pertained to the self-cancelling feature. The Chief Counsel stated its belief that the Section 7520 tables did not apply to value the notes in this situation. It stated that, by its terms, Section 7520 applies only to value an annuity, an interest for life or for a term of years, or any remainder interest following those interests. Instead, the self-cancelling installment note should be valued based on a method that takes into account the willing buyer willing seller standard and this would include taking into account the decedent's life expectancy and the decedent's medical history on the date of the gift. Thus, the IRS tried to make the presumptions in the regulations about life expectancy and use of the tables irrelevant.

7. With respect to the third issue, the Chief Counsel found that this situation was unlike the situation of Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), in which the Tax Court respected the self-cancelling feature of a note and held it would not be included in decedent's estate. In this matter, the Chief Counsel asserted that there

was no bona fide reason, such as need for enhanced cash flow, for adding the self-cancelling feature to the note. The only purpose of the feature was estate planning. In addition, the Chief Counsel questioned whether there was legitimate intent that the note be paid. Based on Estate of Musgrove v. United States, 33 Fed. Claims 657 (1995), the Chief Counsel concluded the note should be included in the decedent's estate. This analysis introduces an element of non-tax business purpose that is new to the analysis of self-cancelling notes.

E. Koons v. Commissioner, T.C. Memo 2013-94

1. The Tax Court in Koons denied a deduction for the interest on a Graegin loan and accepted the discount proposed by the IRS for LLC interests in the estate.

2. At John Koons' death in 2005, his revocable trust had a 46.94% voting interest and a 51.59% non-voting interest in CI LLC. These two interests represented 50.5% of CI LLC. The net asset value of CI LLC on the date of Koons' death was $317,909,786. CI LLC was funded from the proceeds of the sale of the family's Pepsi distributorship business in Cincinnati. The other owners of CI LLC on the date of Koons' death were family members or trusts for their benefit.

3. On the federal and state estate tax returns, the estate reported the fair market value of its interest in CI LLC at $117,197,443. This value was based on a report prepared by Mukesh Bajaj, and included a marketability discount of 31.7%. At trial, the estate lowered the value of the revocable trust's interest in CI LLC to $109,651,854.

4. In February, 2006, CI LLC lent the revocable trust $10.75 million in exchange for a Graegin note to assist in the payment of the federal and state estate taxes. The promissory note for the loan bore interest at 9.5% rate, with repayment deferred for eighteen years and then payment in 14 semi-annual installments of $5.9 million between August 31, 2024, and February 28, 2031. The terms of the loan prohibited pre-payment. As a result of these terms, the total interest on the loan was $71,419,497. The estate deducted the interest amount on the federal estate tax return as a Section 2053 administration expense.

5. The court determined that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. It concluded that there were significant liquid assets in the estate, more than $19 million worth. It noted that when it borrowed the money in February, 2006, because of redemptions of some of the other parties' shares, the estate had 70.42% voting control of CI LLC and the LLC had over $200 million dollars in highly liquid assets. As

a result, the revocable trust had the power to force CI LLC to make a pro rata distribution to its members that could then be used to pay the taxes. This ability to force CI LLC to distribute assets made the borrowing of the $10.75 million unnecessary. The tax court based its determination on the decisions in Estate of Black v. Commissioner, 133 T.C. 340 (2009), and Estate of Stick v. Commissioner, T.C. Memo. (2010-192).

6. The court also rejected the analysis of Mukesh Bajaj, an appraiser often used by the IRS, and one whose work is frequently discredited. The court accepted the IRS valuation of the 50.5% interest in CI LLC as being $148,503,609, using a 7.5% discount.

V. Other Recent Cases and Rulings of Note

A. Trombetta v. Comm'r, T.C. Memo 2013-234.

1. This case provides a textbook illustration of how not to administer a GRAT and QPRT. The grantor and trustees of the trusts failed repeatedly to respect the statutory requirements for the trusts. Both trusts were included in the decedents' estate.

2. In 1993, the taxpayer had created a 15 year GRAT and transferred two commercial rental properties to it. She also created a 15-year QPRT with her personal residence.

3. The taxpayer died in 2006, before the end of the trust terms. This in itself would have caused inclusion of the trusts in her estate.

4. Nevertheless, the court focused on administration of the trusts.

a. The taxpayer did not receive the annuity payments from the GRAT on a regular basis. The trustees modified the payments when the grantor wanted the amounts changed. The grantor also used the GRAT properties as security for a personal loan.

b. When it was clear the grantor was dying, the trustees and the grantor agreed to reduce the annuity term, in an effort to avoid inclusion of the GRAT in her estate.

c. The trustees also attempted to terminate the QPRT early. Before doing so, the trustees created a charitable remainder trust and transferred the residence to that trust.

B. Rachal v. Reitz, 403 S.W. 3d 840 (Tex. 2013)

1. The Supreme Court of Texas held that an arbitration clause in a trust agreement was valid and enforceable against the beneficiaries.

2. One of the settlor's sons, a beneficiary of the trust in question, brought a suit against the trustee alleging that the trustee had misappropriated trust assets and failed to provide an accounting. The beneficiary sought removal of the trustee, an injunction and damages.

3. The trustee invoked the arbitration clause. The trial court and appellate court denied the trustee's motion to compel arbitration. The court of appeals concluded that an arbitration provision is binding only if it is part of an enforceable contract between the parties. The court reasoned that a trust is not a contract. There is no consideration, and the beneficiaries do not bargain for the trust terms.

4. The Texas Supreme Court reversed, based in part on the trust principle that a settlor's intent, as expressed in the trust agreement, is to be enforced whenever possible. The court also noted that the Texas statutes on arbitration refer to an agreement, and are not limited to contracts. The court further stated that a beneficiary can "agree" to the trust terms by accepting the benefits of the trust. Having done so, the beneficiaries were estopped from objecting to the clause.

C. Steinberg v. Comm'r. 141 T.C. No. 8 (2013)

1. In this case, a divided Tax Court raised the possibility that taxpayers who engaged in a net gift transaction might be able to take into account potential estate tax liability in valuing the gift, in addition to the gift tax liability assumed by the donees. The opinion was issued in denying an IRS motion for summary judgment on the issue, so it is premature to label this a clear planning opportunity yet. But it is an interesting development.

2. The net gift transaction is a familiar one in which the donee agrees to pay any gift tax that the donor otherwise would be required to pay. When the donor makes a gift subject to this condition, the amount of the gift is reduced by the amount of the gift tax.

3. One benefit not available with a net gift is the donor avoiding Section 2035(b) inclusion for gift tax paid if the donor dies within three years of the gift. The IRS has ruled on several occasions that the donor's estate is grossed up by the gift tax paid, even if it is paid by someone other than the donor.

4. In Steinberg, the donees, daughters of Mrs. Steinberg, agreed to a net gift in which they were obligated to pay the gift tax liability and also

any additional estate tax liability imposed by reason of Section 2035(b) applying. Mrs. Steinberg reported the gift with a reduction (in the form of a discount) for an amount representing the potential Section 2035(b) obligation. The IRS denied this adjustment.

5. The Tax Court held that the value of the Section 2035(b) obligation was not barred a matter of law from being treated as part of the consideration provided by the daughters. In doing so, the Court acknowledged it was not following its holding in McCord v. Comm'r., 120 T.C. 358 (2003), <u>rev. and remanded</u>, 461 F. 3d 614 (5th Cir. 2006).

   a. The Court rejected the IRS position that any such transfer agreement is presumptively gratuitous. It did state, however, that such agreements among family members are subject to special scrutiny.

   b. The Court also stated that the donee's assumption of potential estate tax liability could be quantified and reduced to a monetary value.

D. <u>Linn v. Department of Revenue</u>, 2013 Ill. App. (4th) 121055, 2 N.E.3d 1203 (4th Dist. 2013)

1. An Illinois Appellate Court held that a trust was not subject to Illinois income tax under the due process clause. The trust at issue had been created when the trustees of an irrevocable inter vivos trust exercised their power to distribute trust property to a new trust. The original trust had been established in 1961 by A.N. Pritzker, when he was an Illinois resident and the original trust was subject to Illinois law by its terms. The trustees and beneficiaries of the original trust were also Illinois residents. However, the trustees exercised their power to transfer assets to or in trust for the beneficiaries to establish a new trust.

2. The new trust stated that it was to be construed and regulated under Texas law, except for the interpretation of the terms “income”, “principal” and “power of appointment”, and the provisions relating to such terms. Later, the trustees obtained an order from the Texas probate court reforming the trust to be subject to Texas law in all respects, as long as the reformation did not jeopardize the generation-skipping transfer tax status of the trust.

3. The trustee of the new trust resided in Texas and the new trust was administered in Texas. None of the beneficiaries of the new trust were Illinois residents and the new trust had no assets in Illinois. In 2006,

the trustee filed a nonresident Illinois income tax return, reporting no income from Illinois sources and no Illinois tax. However, the Department of Revenue reclassified the trust as an Illinois trust and taxed 100% of its income. The trustee appealed.

4. The trial court held for the Department of Revenue that the new trust was subject to Illinois law under the trust agreement of the original trust from which it was created and that being subject to Illinois law was a sufficient contact to allow Illinois to tax the trust under the due process and commerce clauses of the United States Constitution. The trustee appealed again.

5. A trust is subject to Illinois tax if the grantor was domiciled in Illinois when the trust becomes irrevocable (the Illinois statute says a trust is considered irrevocable to the extent that the grantor is not treated as the owner of the trust under Code Sections 671 through 678). On appeal, the parties agreed that the A.N. Pritzker, the grantor of the original trust, is considered to be the grantor of the new trust as well. The main issue, therefore, was a constitutional one: Could Illinois tax the new trust if the only contact with the state was the resident grantor of the original trust?

6. The Illinois Court of Appeals held that Illinois could not tax the trust. The due process clause requires there to be minimum contacts between the state and the person or property it taxes. The Department of Revenue argued that even though the trustee, beneficiary, trust protector and assets were all outside of Illinois, the new trust owed its existence to Illinois law and that Illinois provided legal benefits and opportunities to the trust. However, the Court disagreed and held that the residence of the grantor alone was insufficient to establish a minimum connection that would permit Illinois to tax the trust under the due process clause. The Court reasoned that the trust owed its existence to the exercise of a power of appointment under the original trust agreement, but not to Illinois law. It also noted that for the tax year in question, the new trust was subject to Texas law exclusively and would receive benefits and protections of Texas law, but not Illinois law.

7. The case is interesting as decanting and exercises of powers of appointment become more common for income tax planning. The Court noted that the new trust was created by the trustees using a provision of the original trust, not by the Illinois decanting statute. It is therefore not clear if the result would be the same if the trustees had relied on a state statute to decant the trust.

E. <u>McNeil v. Commonwealth of Pennsylvania</u>, 67 A.3d 185 (May 24, 2013)

1. The court considered the ability of the Commonwealth of Pennsylvania to tax a trust created by a Pennsylvania resident, but governed by Delaware law, with a Delaware administrative trustee and with three other trustees residing outside of Pennsylvania. The trust had no Pennsylvania assets or income, but all of the trust's discretionary beneficiaries resided in the state. All trust distributions were discretionary.

2. Under Pennsylvania statute, the income of any "resident trust" is taxed. A resident trust is (1) a trust created by the will of an individual who at the time of his death was a resident of Pennsylvania, or (2) a trust created by a person who at the time of the creation was a resident. Because the settlor was a resident of Pennsylvania when the trust was created in 1959, all trust income was taxable under Pennsylvania statute, and the Pennsylvania Department of Taxation assessed taxes, interest and penalties accordingly.

3. However, the Commonwealth Court held that the application of the state income tax to the trust violated the Commerce Clause of the U.S. Constitution because:

    a. The trust lacked a substantial nexus with the state. Although the beneficiaries reside in Pennsylvania, they had only a discretionary interest and therefore no current or future right to the trust assets. The settlor's residence in Pennsylvania in 1959 when the trusts were created likewise was not enough to establish substantial nexus.

    b. The settlor, a Pennsylvania resident, had not retained powers over the trust.

    c. The imposition of the tax fails the "fair apportionment test," which allows taxation of only the portion of taxable activity that occurs within the state imposing the tax. The trust did not derive any income from Pennsylvania and did not have any assets or interests in the state. Therefore imposing tax on all of the trust's income was "plainly out of all proportion" to the trust's business activities in the state (one of the Pennsylvania Supreme Court's standards for the fair apportionment test).

    d. The taxes were not fairly related to Pennsylvania because the trust had no physical presence in the state, had no in-state assets or income, was governed under Delaware law and did not benefit from the state's roadways, bridges, police, fire protection, economic markets, workforce, courts or laws.

F. Adler v. Greenfield, 2013 Ill. App. (1st) 121066, 990 N.E.2d 1219 (1st Dist. 2013)

1. An estate-planning attorney was sued for failing to include a clause exercising of a power of appointment in the will of his client, Muriel Perry. During the course of that litigation, the court directed the parties to seek information from the Mrs. Perry’s financial advisor, JPMorgan. JPMorgan objected to the production of communications JPMorgan had with Mrs. Perry’s counsel about the estate plan during her lifetime on the grounds of attorney-client privilege. The trial court overruled objections to production, holding that the communications were not privileged, and ordered the issuance of a subpoena to JPMorgan. JPMorgan still did not produce the communications, and the trial court found JPMorgan in contempt, imposing a sanction of $100 to enable appellate review of the privilege issue.

2. The Illinois Appellate Division reversed the trial court and held that communications between JPMorgan and Mrs. Perry’s counsel during her life were protected by the attorney-client privilege because JPMorgan was acting as Mrs. Perry’s agent, and communications between an agent and the principal’s counsel during the principal’s lifetime are privileged as though the communications were directly between the principal and counsel. The Appellate Division concluded that JPMorgan was acting as Mrs. Perry’s agent based on several letters from JPMorgan to the estate-planning attorney in which JPMorgan communicated specific changes requested by Mrs. Perry to her estate plan.

G. Estate of Giovacchini, T.C. Memo 2013-27

1. The court determined that a sale of the subject property 16 months after the decedent's death was the best evidence of value for both the estate and a prior gift by the decedent.

2. Shirley C. Giovacchini died on October 8, 2001. Shirley had owned a unique piece of real estate near Lake Tahoe, California called High Meadows. High Meadows covered approximately 2,350 to 2,500 acres and parts of it were quite mountainous and difficult to accurately survey or measure.

3. In 1999, Shirley transferred ownership of High Meadows to herself and her daughter, Lisa Lekumberry, as trustees of the Giovacchini Family 1989 Trust. On June 27, 2000, the trust sold a 50 percent interest in High Meadows to High Meadows Six LLC, which was an entity controlled by Shirley's three daughters and their spouses. High Meadows Six LLC paid $2.5 million for its 50 percent interest. No

appraisal was done with respect to the sale of the 50 percent interest. The sale price was determined by the family and by the family's CPA using the value determined by the appraisal for the estate of Shirley's husband, Roy Giovacchini, who died in 1997, plus an annual increase for inflation based upon the consumer price index.

4. At Shirley's death, Shirley owned one-half of High Meadows and High Meadows Six LLC owned the other one-half. The estate argued that the value of the entire High Meadows property was $7.4 million in 2000 and $8 million in 2001. (The parties agreed that depending upon the value, the sale of a 50 percent interest to High Meadows Six LLC in 2000 was a part sale and part gift.) The IRS argued that the values were $25 million in 2000 and $36 million in 2001, respectively, based upon a subsequent sale of a large part of the High Meadows property to the U.S. Forest Service that occurred in 2003. The $29,500,000 price paid for the large part of High Meadows was based upon a December 2002 appraisal.

5. In determining that the January 31, 2003 sale of High Meadows was the best evidence of the value of High Meadows for both estate and gift tax purposes, the court acknowledged that subsequent events are generally irrelevant and therefore inadmissible in determining the fair market value of property as of a relevant valuation date. But it said that the guideline is generally inapplicable when the subsequent event is a sale of the subject property itself within a reasonable time of the relevant valuation date, and there were no "material changes in circumstances occur between the valuation date and the date of sale."

6. The court then engaged in a long analysis of the impact of the passage of time since the date of death, and of the different appraisals offered by the estate and the IRS. It determined that the value of High Meadows for estate tax purposes was $21,300,000 as of October 8, 2001. It determined that the value of High Meadows for gift tax purposes in 2000 was $18,500,000.

H. Private Letter Ruling 201310002 (Nov. 7, 2012)

1. The IRS ruled on the income and gift tax consequences of a trust intended to be an incomplete gift, non-grantor trust. (A trust of this nature is commonly referred to as a Delaware incomplete gift non-grantor trust or “DING,” if created under Delaware law, or a Nevada incomplete gift non-grantor trust or “NING,” if created under Nevada law.) As its name implies, a DING or a NING is structured to be a non-grantor trust for income tax purposes that is funded by transfers from the grantor that are incomplete gifts for gift tax purposes. Assuming the trust is established in a state that doesn’t tax the income

accumulated in the trust (like Delaware or Nevada), the trust will avoid state income taxes as long as the state of residence of the grantor or beneficiaries doesn't subject the trust's income (or accumulated income) to tax. Moreover, if structured and administered properly, the trust property should be protected from the grantor's creditors. The DING or the NING allows a grantor to achieve both of these benefits while still being able to receive discretionary distributions of trust property and without paying gift tax (or using any gift tax exemption) on the transfer of property to the trust. A gift from the grantor will be complete upon a subsequent distribution from the trust to a beneficiary other than the grantor, and whatever property remains in the trust will be subject to estate tax at the grantor's death.

2. In Private Letter Ruling 201310002, the grantor established an irrevocable trust for the benefit of himself and his issue, with a corporate trustee as the sole trustee. During the grantor's lifetime, the trustee could distribute trust income and principal only as follows:

    a. to the grantor or his issue as directed by a majority of the "Distribution Committee" members with the grantor's written consent ("Grantor's Consent Power"); and

    b. to the grantor or his issue as directed by all of the Distribution Committee members other than the grantor ("Unanimous Member Power").

3. The grantor and his four sons were the initial members of the Distribution Committee. The trust provided that the Distribution Committee would cease to exist any time less than two "Eligible Individuals" (i.e., adult issue of the grantor or the parent or guardian of minor issue of the grantor) were members of the Distribution Committee. The ruling indicates that the trust required that *any* vacancy in the Distribution Committee be filled by an Eligible Individual in the manner indicated in the trust; however, the attorney who sought this ruling has since clarified to us that a vacancy in the Distribution Committee was only required to be filled by an Eligible Individual if the Distribution Committee would otherwise be comprised of less than two members. The Distribution Committee would permanently cease to exist upon the grantor's death.

4. The grantor (acting in a non-fiduciary capacity) could distribute *principal* to his issue for their health, education, support and maintenance under a lifetime power of appointment ("Grantor's Sole Power"). The grantor also had a limited testamentary power of appointment, which allowed him to direct the trustee to distribute trust property to any person or entity other than himself, his estate, his

creditors or the creditors of his estate ("Grantor's Testamentary POA"). On the grantor's death, in default of the exercise of the Grantor's Testamentary POA, the trust property was to be distributed among separate trusts for the benefit of the grantor's issue.

5. The IRS first ruled that the trust wouldn't be a grantor trust to the grantor while the Distribution Committee was serving. In support of this conclusion, the IRS stated only that an examination of the trust revealed no circumstances that would cause the grantor to be treated as the owner of any portion of the trust under IRC Sections 673-677, inclusive.

6. IRC Section 674(a) provides that a grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment is subject to a power of disposition exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party. However, under IRC Section 674(b)(5), this rule does not apply to a power to distribute *corpus* to or for a beneficiary or beneficiaries that is limited by *a reasonably definite standard* that is set forth in the trust instrument.

7. For purposes of the grantor trust rules, "adverse party" is defined in IRC Section 672(a) as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power at issue. The grantor's descendants in this ruling were all "adverse parties" for purposes of the grantor trust rules because they were all beneficiaries of the trust and as such, their interests could be adversely affected by the grantor's (or their fellow beneficiaries') exercise or nonexercise of their powers of disposition with respect to the trust property. As the Distribution Committee would always be comprised entirely of the grantor's descendants (or their legal guardians), the Distribution Committee would always be comprised entirely of adverse parties.

8. Applying the foregoing, one can determine how the IRS reached its conclusion that the trust wouldn't be a grantor trust to the grantor while the Distribution Committee was serving. The Grantor's Consent Power did not give the grantor alone the power to dictate whether a *distribution* of trust property would be made -- the consent and direction of adverse parties (i.e., a majority of the members of the Distribution Committee) was also required. Moreover, the Unanimous Member Power ensured that the grantor alone did not have the power to *withhold* all distributions from the trust by virtue of his non-exercise of the Grantor's Consent Power. Finally, the Grantor's Sole Power did not cause the trust to be treated as a grantor trust because it was a power to distribute only corpus to the trust beneficiaries that was

limited to a reasonably definite standard (health, education, support and maintenance).

9. Although the trust's governing law was not disclosed in this ruling, only Nevada law at the time allowed a grantor to retain a lifetime power of appointment over a trust he creates without subjecting the trust assets to the claims of his creditors. A trust that is reachable by a grantor's creditors would likely be deemed a grantor trust as to the grantor under IRC Section 677 (see Treasury Regulations Section 1.677(a)-1(d)). Accordingly, because the trust in this ruling was determined to be a non-grantor trust even though the grantor retained the Grantor's Sole Power, the trust must have been a Nevada trust. Other states have since enacted statutes allowing a grantor to retain a lifetime power of appointment over a trust without subjecting the trust assets to the claims of his creditors.

10. The IRS next ruled that the contribution of property to the trust by the grantor would not be a completed gift because the grantor retained the Grantor's Consent Power and the Grantor's Sole Power.

11. Under Section 25.2511-2(c) of the Treasury Regulations, a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, the Grantor's Sole Power rendered the grantor's gifts to the trust wholly incomplete because it gave the grantor the power, acting in a non-fiduciary capacity, to change the interests of the beneficiaries of the trust. (The IRS also concluded that the Grantor's Testamentary Power rendered the grantor's gifts to the trust incomplete with respect to the *remainder interest* in the trust.)

12. The IRS also concluded that the Grantor's Consent Power rendered the grantor's gifts to the trust wholly incomplete. Under Section 25.2511-2(e) of the Treasury Regulations, a donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a "substantial adverse interest" in the disposition of the transferred property or the income therefrom. Accordingly, the Grantor's Consent Power would render gifts by the grantor to the trust incomplete unless the Distribution Committee members had "substantial adverse interests" in the disposition of the trust property. Although "substantial adverse interest" is not defined in Section 25.2511-2(e), the IRS looked to the Treasury Regulations under IRC Section 2514 (regarding Powers of Appointment) which provide (1) that a taker in default of appointment under a power has an interest that is adverse to an exercise of the power, and (2) that a co-holder of a

power does not have an adverse interest merely because of his joint possession of the power or because he is a permissible appointee under the power, but the co-holder does have an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate (Treas. Reg. § 25.2514-3(b)(2)). With respect to the Grantor's Consent Power, the IRS stated that the Distribution Committee members were not takers in default. This makes sense because trust property would not automatically be distributed to the Distribution Committee members (or any other trust beneficiary) upon a non-exercise of the Grantor's Consent Power. Rather, the IRS concluded that the Distribution Committee members were co-holders of the Grantor's Consent Power. However, as the Distribution Committee ceases to exist after the grantor's death, the Distribution Committee members could not exercise the Grantor's Consent Power after the grantor's death in favor of anyone, much less themselves, their estates, their creditors or the creditors of their estates. Accordingly, even though the Distribution Committee members were "adverse parties" for purposes of the grantor trust rules, the IRS concluded that they did not have "substantial adverse interests" to the grantor for purposes of Section 25.2511-2(e) of the Treasury Regulations. As a result, the grantor's retention of the Grantor's Consent Power rendered his gifts to the trust incomplete.

13. Because the grantor's contributions of property to the trust were not completed gifts, the IRS reasoned that any distribution from the trust to the grantor was "merely a return of [the grantor's] property." Accordingly, the IRS ruled that any such distributions to the grantor would not be completed gifts by any member of the Distribution Committee.

14. Finally, the IRS ruled that no distribution of trust property by the Distribution Committee to any beneficiary other than the grantor would be a completed gift by any member of the Distribution Committee. In other words, the Distribution Committee members' powers pursuant to the Grantor's Consent Power and the Unanimous Member Power did not qualify as general powers of appointment under IRC Section 2514, as explained below.

15. Under IRC Section 2514(c)(3)(A), a power that is exercisable only in conjunction with the creator of the power will not be deemed a general power of appointment. Because the Grantor's Consent Power only allowed the Distribution Committee members to distribute trust property to themselves (or to any other beneficiary) with the consent of the creator of this power (i.e., the grantor), the IRS concluded that none of the Distribution Committee members had a general power of

appointment over the trust property by virtue of the Grantor's Consent Power.

16. Moreover, the IRS concluded that none of the Distribution Committee members had a general power of appointment over the trust property by virtue of the Unanimous Member Power. Under IRC Section 2514(c)(3)(B), if a power is exercisable by the possessor only in conjunction with a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the possessor, the power will not be deemed a general power of appointment. So, if the Distribution Committee members' interests in the trust property were deemed "adverse" to each other under IRC Section 2514, the members' power to make distributions to themselves pursuant to the Unanimous Member Power would not be a general power of appointment.

17. As noted above, co-holders of a power are not adverse solely because of their joint possession of the power or because either or both of them are permissible appointees under the power; however, co-holders do have adverse interests where one may possess the power after the other's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. The IRS likened the situation at hand to the example in Section 25.2514-3(b)(2) of the Treasury Regulations in which three persons (X, Y and Z) hold a joint power to appoint among a group of persons which includes themselves. If on X's death the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. If on Y's death the power will pass to Z, then Z is considered to have an interest adverse to the exercise of the power in favor of Y. The IRS stated that as in this example, "the Distribution Committee members have substantial adverse interests in the property" subject to the Unanimous Member Power such that they did not have general powers of appointment over the trust property by virtue of the Unanimous Member Power.

18. So, the Distribution Committee members were determined *not* to have "substantial adverse interests" to the grantor in regards to the Grantor's Consent Power because they would not be able to exercise the Grantor's Consent Power after the grantor's death. However, the Distribution Committee members were determined to have "substantial adverse interests" to each other in regards to the Unanimous Member Power because a deceased member's power would pass to the surviving members upon the deceased member's death.

19. Although it is not addressed in the Regulations, when Z in the example set forth above is the sole remaining powerholder, he presumably will have a general power of appointment. Similarly, if the Distribution Committee in the ruling were ever reduced to one member, that member would presumably be deemed to have a general power of appointment over the trust property. The trust sought to address this problem by providing that the Committee would cease to exist if it were ever comprised of less than two members. However, if the Committee would disband when its membership became less than two persons as provided in the trust, then arguably the Committee members' interests would cease to be adverse when only two Committee members are left because the survivor of the two members would not inherit the deceased member's power upon the deceased member's death. To illustrate using the example in the Regulations, assume the trust creating the power at issue provides that the power evaporates when two of the three powerholders die. In that case, Y and Z will no longer have adverse interests after X dies because the power will evaporate (rather than pass to Z) upon Y's death. Moreover, this problem cannot be solved by simply increasing the minimum number of powerholders that are required for the power to remain in existence--the problem will always rear its head when it's down to the minimum required number of powerholders, regardless of what that minimum number may be.

20. Although the IRS did not address the foregoing wrinkle in the ruling, its conclusion that the Distribution Committee members did not have general powers of appointment over the trust property (such that distributions from the Committee would not constitute gifts from any Committee member), was logical and consistent with its determination that the grantor's contributions to the trust were incomplete gifts. Otherwise, what would be the effect of a distribution from the trust to the grantor? Would it be "merely a return of [the grantor's] property" or would it be a gift from the Distribution Committee members? Reason dictates that it couldn't be both. Moreover, what would be the effect of a distribution to a beneficiary other than the grantor? Would it be a completed gift from the grantor or a completed gift from the Distribution Committee members? Perhaps it would be deemed a completed gift from the grantor to the trust followed by a completed gift from the Distribution Committee members to the trust beneficiary (i.e., two gifts), but that would be a harsh and somewhat illogical result.

21. Despite these unanswered questions, this ruling demonstrates that the incomplete gift non-grantor trust is alive and well.

I. Letter Ruling 201332001 (May 10, 2013)

1. A taxpayer and his wife established a trust that purchased a joint and survivor insurance policy on their lives. Upon the death of the survivor of the taxpayer and his wife, the trust provided that the trustees were to distribute the trust property outright to the couple's four children. The couple's daughter was subsequently diagnosed with a disability that would limit her ability to manage her affairs. To protect the trust property and his daughter, the taxpayer established a second trust that was a grantor trust to the taxpayer and that had the same beneficiaries and trustee as the first trust, but included special needs provisions for his daughter's share. The taxpayer and his wife also established a partnership that held several investment properties. The second trust intended to purchase the joint and survivor insurance policy from the first trust.

2. In general, amounts received under a life insurance policy upon the death of the insured are excluded from gross income under IRC Section 101(a)(1). However, the transfer-for-value rule in IRC Section 101(a)(2) provides that if a life insurance policy is transferred for valuable consideration, the amounts later received under the policy by the purchaser in excess of the consideration and premiums paid aren't excluded from gross income. An exception to the transfer-for-value rule is found in IRC Section 101(a)(2)(B) which provides that the rule doesn't apply if the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

3. Because the second trust planned to purchase the joint and survivor life insurance policy from the first trust, the transfer-for-value rule was implicated in this Ruling. However, the IRS concluded that this purchase would fall within the exception to the transfer-for-value rule found in IRC Section 101(a)(2)(B). As the second trust was a grantor trust to the taxpayer, the taxpayer and the second trust were treated as one for federal income tax purposes. Accordingly, to the extent the policy insured the taxpayer's life, the transfer to the second trust was a transfer "to the insured." Moreover, to the extent the policy insured the life of the taxpayer's wife, the transfer to the second trust was a transfer to a "partner of the insured" by virtue of the taxpayer's and his wife's partnership.

4. It is not uncommon for a joint and survivor life insurance policy to be owned by a trust that is a grantor trust as to only one of the insureds. If the joint and survivor policy is to be transferred to the trust for valuable consideration, this ruling illustrates that the transfer will not fully escape the transfer-for-value rule unless the insured who is not the grantor of the trust is a partner of the insured who is the grantor of the trust.

J. Letter Ruling 201330011 (July 26, 2013)

1. The IRS confirmed that amounts of income in respect of decedent from IRAs assigned and transferred to charities pursuant to decedent's estate plan will only be included in the income of the two charities

2. The estate plan of the decedent in this case consisted of a pour over will and to a revocable trust. The residuary provision of the revocable trust provided that upon the decedent's death, two charities would share in the residue of the estate. A bank was both the personal representative of the decedent's estate and the trustee of the trust. The bank as personal representative and trustee intended to assign and transfer all of the decedent's IRAs to the two charities in accordance with the residuary provisions of the trust.

3. The issue here was whether a transfer had occurred under Section 69l(a)(2), which provides generally that the transfer of IRD by an estate causes the IRD to be included in the gross income of the estate. Under Section 691(a)(2), a transfer does not include the transmission upon death to the estate of the decedent or to a person entitled thereto by bequest or devise. The IRS looked to Treas. Reg. 1.691(a)-4(b)(2), which provides that, if a right to IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the IRD in income. Many IRA custodians do not understand this rule, and will insist on issuing a Form 1099 to the estate when the transfer is made.

VI. Conclusion

Ben Franklin provided the estate planning industry with one of its favorite quotes ("..in this world nothing can be said to be certain, except death and taxes"). It seems there are two additional certainties in our industry: that the tax rules will continue to change, and that planning will continue to change and evolve in response. As trusts and estates professionals, we must be ready to adapt to the changing rules and to draft flexible trusts, as it is likely that future developments or changes in the law may make it desirable to change the trust in ways not anticipated in the governing instrument.

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Financial Executive Dialogue

Meet for peer dialogue around topics of interest to your office. Choose from these office types:

Small Office (less than 7 staff) **–** Monroe Room
Medium Office (8-14 staff) **–** Spire Parlor
Large Office (15 or more staff) **–** Adams Room
MFOs, Wealth Advisors & Thought Leaders Council Members – Wabash Room

Notes:

Notes:

Human Capital Trends and Insights

This informative session will provide insight into many of the current trends in various key areas of human capital: performance measurement, benefits, new legal considerations and DOL focuses, and other policy considerations. Dawn will be joined by Melissa, Seibert who will share the legal perspective on topics family offices need to be aware of in the employment arena.

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Dawn M. Rose
Director of Human Capital

Dawn collaborates with senior management to implement human capital strategy at FOX, including organizational design, talent acquisition, performance development and assessment, employee/labor relations, compensation, benefits, and legal compliance. She joined FOX from the University of Chicago, where she served as the Director of Human Capital for faculty and staff in the Department of Surgery. She has more than 15 years of experience in human resources and earned her Professional in Human Resources (PHR) certification from the HR Certification Institute in 1998. She graduated with her Juris Doctor from Chicago-Kent College of Law in 2007, where she also earned a Certificate in Labor & Employment Law. She has volunteered as a pro bono attorney for Equip for Equality, The Chicago Lighthouse for People Who Are Blind or Visually Impaired, and the Illinois Lawyers' Assistance Program, as well as serving on boards with the American Cancer Society – Chicago Chapter, The Chicago Lighthouse, and Sixty Inches from Center, a nonprofit organization that documents, archives, and engages with the visual arts community in Chicago.

Melissa Seibert
Partner, BakerHostetler

Melissa Siebert concentrates her practice in employment litigation, class and collective action litigation, and employment law counseling. Melissa's combined legal and human resources/business experience allows her to provide effective and efficient counsel on a variety of strategic and day-to-day issues, including the interaction between the FMLA, ADA and workers' compensation, restrictive covenants, company-wide policy creation and implementation, employee investigations, discipline and termination, and employment agreements. She also has substantial experience representing employers in labor matters, both as in-house and outside counsel. Melissa focuses on class and collective action litigation, representing employers involved in significant EEOC "pattern and practice" investigations/lawsuits, and putative class/collective actions under the FLSA, the FCRA, and state laws.

Notes:

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Family Office Exchange

Human Capital Trends & Insights

Dawn M. Rose, Director of Human Capital, Family Office Exchange
Melissa A. Siebert, Partner, BakerHostetler

Financial Executives Forum, Wednesday, July 23, 2014

Surveying the Landscape

Global competition for skilled and educated workers

Five generations of employees working in a global environment

Increased contingent labor pool

Increased demand for workplace flexibility and work/life balance

Developments in information and communications technologies

Continuing impact of economy on budgets, hiring, and human capital strategies

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Traditional and Modern Roles of Family Offices

Traditional Family Office Roles

- Investment strategy (asset allocation)
- Security selection (versus manager selection)
- Investment oversight
- Tax administration
- Estate administration
- Narrower risk management
- Balance sheet and financial planning
- Consolidated reporting
- Philanthropy (rarely strategic)
- Trust and fiduciary services
- Lifestyle management
- Planning family meetings

Modern Family Office Roles

- Responsible ownership
- Legacy
- Multi-generation education programs
- Highly developed family governance
- **Leadership training**
- Family communication (online access)
- **Best practices / peer benchmarking**
- **Broad performance measurement**
- Involvement in membership and peer organizations
- Multi-faceted strategic planning
- **Broader risk management**
- Entrepreneurial programs (including family bank, etc.)

Leading family offices will have additional services and capabilities they provide or coordinate in a systematic manner, including a focus on family continuity.

Legislative Landscape

- Fair Labor Standards Act
- Family and Medical Leave Act
- National Labor Relations Act
- Patient Protection and Affordable Care Act (PPACA)
- Right to Know proposed rule
- Healthy Workplace Bill
- Ban the Box

Legal Landscape – Potential Liability

Courts are increasingly finding liability against entities and at times, against individual managers, owners, officers, and executives

- Fair Labor Standards Act
- Family Medical Leave Act
- Sexual Harassment
- Discrimination
- Equal Pay Act
- Retaliation
- Breach of Contract/Employment Agreement
- Benefits & Health (ERISA, HIPAA)
- Personal Tort Actions

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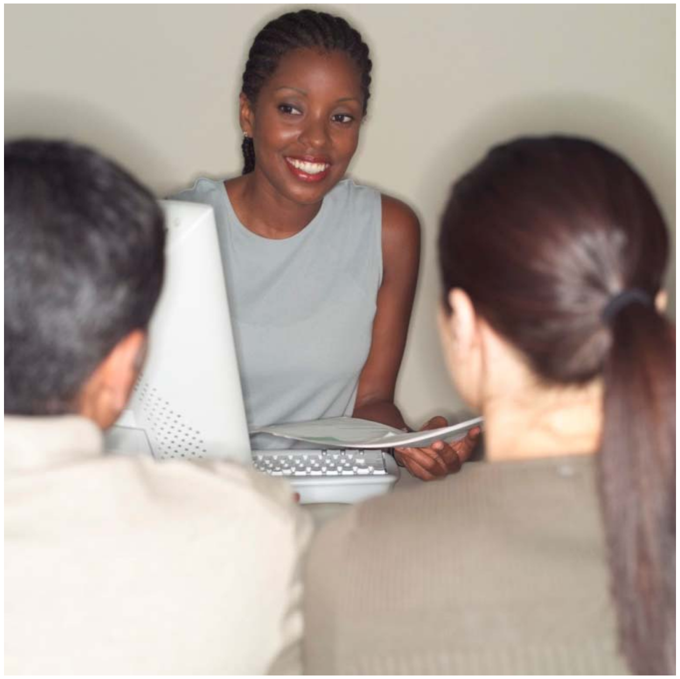
EEOC adamantly opposes use of background checks and credit checks

States & Municipalities are enacting significant restrictions on background check processes



Plaintiffs are using the Fair Credit Reporting Act offensively

Employment Contracts

Pros

- ✓Confidentiality
- ✓ Clear Terms (no outside agreements)
- ✓ Retention

Cons

- ✓ Can alter at-will employment/create rights
- ✓ Terms can be challenged by third parties (e.g. NLRB; EEOC; DOL)
- ✓ Make separations more complicated

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Agency Challenges to Private Employers

EEOC Challenging Releases

NLRB Challenging Non-Union Employer Policies regarding social media

DOL Increasing Enforcement of FMLA and Wage/Hour via agency action and “the bridge to justice”

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Wage and Hour Issues

- Exempt/non-exempt status continues to be hotly-litigated

- March 2014 – White House directs to DOL to “modernize and streamline” regulations regarding executive, administrative and professional exemptions

- *Restoring Overtime Pay for Working Americans Act* introduced in Senate

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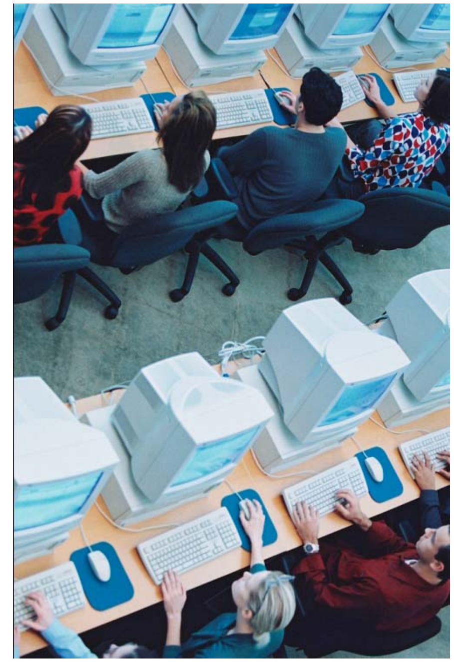
Training & Development

- Reinforce culture & values
- Clarify expectations
- Fulfill legal mandates
- Close skills gaps
- Impact the bottom line
- Provide a defense against claims



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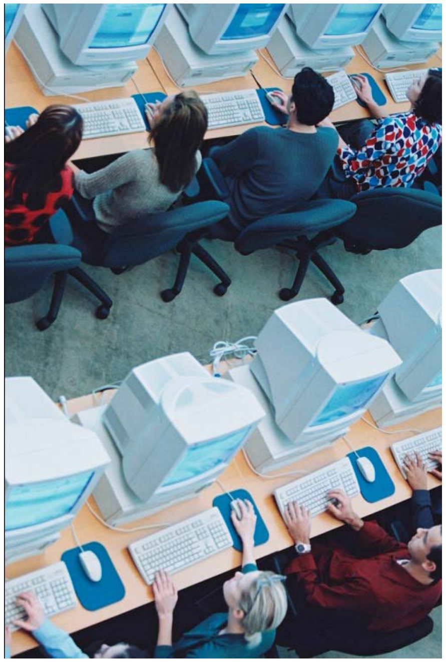
Training & Development

"High-impact companies in the United States spend more than $3,500 per person each year to develop mid-level leaders and over $10,000 to develop senior leaders."

Source: O'Leonard and Loew, Leadership Development Factbook 2012

The average annual direct expenditure for training and development per employee is $1,195

Source: Association for Talent Development 2013 State of the Industry Report



"A new leader typically needs 18 months before feeling fully comfortable in a new role; for a mid-level leader, the time period stretches from 24 to 36 months."

Source: Deloitte Global Human Capital Trends 2014: Engaging the 21st Century Workforce

Questions

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2014 FOX Member Events - Global

Family Office Exchange

January	February	March	April	May	June	July	August	September	October	November	December
Forums*											
			Wealth Advisor Forum Apr 23-25 Chicago			**FOX Financial Executives Forum** Jul 22-23 Chicago			**FOX Fall Forum** Oct 28-30 Chicago		
FOX Educational Programs and Workshops*											
			CHICAGO BOOTH **Private Wealth Management** Apr 29-May 2 Chicago					**Private Family Trust Company Symposium** Sep 22-23 Chicago	CHICAGO BOOTH **Private Wealth Management** Oct 14-17 Chicago		
Webinars*											
The Philanthropic Conversation: What Clients Expect from Their Advisors Jan 22	**Strangers in Paradise: How Families Adapt to Wealth Across Generations** Feb 12	**Becoming ONE… Navigating Family Governance in a Blended Family** Mar 12	**CRM Solutions – Interoperability with Existing FO Systems** Apr 9	**Administering the Private Trust Company – Key Issues to Consider** May 7	**Tax and Estate Planning Issues of Multijurisdictional Cross-Border Families** Jun 11	**Behavioral Health Risks in Families of Wealth** Jul 9	**Organization and Operation of PFTCs: Building Effective Boards** Aug 20	**Health Challenges- The Aging Family Population** Sep 10	**Investments - Crowd Funding** Oct 1	**FOX 2014 Family Office Benchmarking Survey** Nov 12	**Topics of Concern to Global Members** Dec 3
2014 Estate Planning Update Jan 29	**Finding Investment Opportunities, The Year of the Alligator: Contrarian Opportunities for 2014** Feb 26	**Recruiting and Retaining Executive Talent** Mar 26	**Trends in the Private Equity Secondary Market** Apr 30	**Hot Topic: The Affordable Care Act** May 14	**Talent Management & Acquisition: the Case for Effective Onboarding** Jun 25	**2014 FOX Investment Survey Report and Findings** Jul 16		**Talent Management - Leadership** Sep 17	**Risk Management - Understanding Captives** Oct 8	**Philanthropy - Topic TBD** Nov 19	**Human Resources- Compensation: Incentives and Equity** Dec 10
				Mind the Gap: What are the Key Service Differentiators in the Family Wealth Management Industry? May 21				**Governing the Next Generation from Abroad** Sep 24	**Preparing the Next Generation for Your Family Wealth Journey** Oct 15		
Councils											
Financial Executive Council Jan 30-31 Orlando	**Investment Council** Feb 10-11 NYC	**Sr. Management Council** Mar 6-7 Orlando	**Wealth Advisor Council - Europe** Apr 8 Paris	**Owner/Operator Council** May 6-7 Chicago	**Investment Council** Jun 11-12 Chicago	**Financial Executive Council** Jul 21-22 Chicago	**Wealth Advisor Council - Australia** Aug 12 Melbourne	**Global Family Council** Sep 30-Oct 1 London	**Wealth Advisor Council - Europe** Oct 3 London	**Sr. Management Council** Nov 5-6 San Francisco	
	Family Business Council Feb 25-26 Tampa	**U.S. MFO Council** Mar 12-13 NYC	**Global Family Council** Apr 10-11 Paris			**Thought Leaders Council Summit** Jul 21-22 Chicago	**Family Enterprise Council** Aug 13 Melbourne	**Wealth Advisor Council - U.S.** Sep 11 NYC	**Executive Council** Oct 7-8 Seattle		
	Executive Council Feb 27-28 Tampa							**Executive Council** Sep 8-9 San Francisco			

As of July 17, 2014. Dates subject to change. For updates and event details, please visit: www.familyoffice.com/learning-events

*Eligible for CPE credit

2014 FOX Member Events - Global

Family Office Exchange.

January	February	March	April	May	June	July	August	September	October	November	December
Regional Member Briefings and Roundtables											
	Family Enterprise Best Practice Roundtable Feb 25 Sydney **Family Enterprise Best Practice Roundtable** Feb 27 Melbourne	**Regional Member Briefing** Mar 20 Chicago	**Family Office Roundtable** TBD London	**Regional Member Lunch** May 21 Boston	**Regional Member Briefing** Jun 16 NYC **Regional Member Briefing** Jun 26 SFO		**Melbourne Roundtable** Aug 20 Australia	**Regional Member Lunch** Sep 18 Philadelphia **Family Office Roundtable** Sep 29 London		**Regional Member Briefing** Nov 20 NYC	
Wealth Advisor Briefings											
	Wealth Advisor Best Practice Roundtable Feb 24 Sydney **Wealth Advisor Best Practice Roundtable** Feb 26 Melbourne	**Wealth Advisor Briefing** Mar 19 Chicago		**Wealth Advisor Briefing** May 21 Boston	**Wealth Advisor Briefing** Jun 17 NYC **Wealth Advisor Briefing** Jun 25 SFO			**Wealth Advisor Briefing** Sep 18 Philadelphia		**Wealth Advisor Briefing** Nov 19 NYC	
All Member Networking Events											
								All Member Networking FOX 25th Anniversary Celebration Sep 10 NYC			

As of July 17, 2014. Dates subject to change. For updates and event details, please visit: www.familyoffice.com/learning-events

*Eligible for CPE credit

Family Office Exchange Publications and Research

Central to the FOX mission is the study of issues that members face in leading their families, managing their assets, and operating their family offices. These are the most recent FOX research studies by topic.

Enterprise Family Planning

Securing the Future: Managing Threats and Opportunities through Effective Risk Planning

Taking the Long-Term View of the Family Enterprise

The Challenges of Shared Ownership

The State of the Art in Family Wealth Management

Family Business

Boundaries that Matter: Managing Family Assets Separately from the Family Business - SFO Solution

Managing Family Capital Generated by the Family Business

Protecting the Future: Managing Family Wealth Separately from the Family Business - MFO Solution

Investing

2014 FOX Global Investment Survey

Investing Amid Uncertainty

Navigating the Wealth Management Landscape

Rethinking Investment Risk Management

Selecting the Right Trusted Advisor

Risk

Building a Family Enterprise Plan to Deal With Future Uncertainty

Insurance Matters: The Case for Strategic Insurance Planning

Recasting the Central Role of the Family Office as Risk Manager

Securing the Future: Managing Threats and Opportunities through Effective Risk Planning

Small Family Office Sustainability

Innovating to Survive and Thrive: Meeting the Challenge of Small Family Office Sustainability

Investing in the Future: A Look Inside the Small Family Office

Bold title published in 2014

List as of 06/13/2014

Single Family Office Practices

50 Best Practices for an Enduring Family Enterprise

FOX Benchmarking 2013: Compensation and Benefits Survey

FOX Benchmarking 2013: Investment Survey

FOX Benchmarking 2013: Technology in the Family Office

FOX Guide to the Professional Family Office

FOX Insights: New Thinking in Family Wealth

How Wealth Owners Measure Value: Evaluating the Performance of Your Wealth Advisor or Family Office

The Cost of Complexity: Understanding Family Office Costs

Technology and Reporting

Best Practices in Reporting Toolkit

Financial Reporting in the Family Office

FOX Technology Guide

Wealth Owner Education

FOX Guide to Family Education

Global Family Office Primer: Purposeful Management of Family Wealth

Preparing the Next Generation for the Responsibilities of Ownership

U.S. Family Office Primer: Purposeful Management of Family Wealth

Multi-Family Office Practices

2012 Multi-Family Office and Wealth Advisor Benchmarking

Best Practices for Leading Wealth Advisors

The FOX Wealth Advisor Series

Enhancing the Client Service Experience

Standing Out in the Crowd: Strategies for Marketing and Leveraging Relationships

The Enduring Enterprise: Building a Sustainable Wealth Advisory Business

The Enterprise Sales Process: Best Practices in Business Development

Pricing for Profitability: Pricing Practices in an Evolving Ultra-Wealth Marketplace

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Family Office Exchange® | 25 Years 1989 - 2014

FOX FALL FORUM

Mark your calendar for the 25th Anniversary Celebration at the FOX Fall Forum, October 28-30 in Chicago. Here's a quick preview:

Tuesday, October 28

- Opening luncheon at noon
- Afternoon workshops – concentrated learning opportunities
    - Dr. R. Kelly Crace will provide guidance on how to position your family for leadership
    - The 2014 Family Office Benchmarking Survey will convey insight into best practices
    - Data security and privacy issues will be addressed and solutions will be identified
    - Direct Investing Network members will discuss investment trends and direct deal experiences

Social Event: A private dinner for family members and office executives in the **Modern Wing of the Art Institute of Chicago.**

Wednesday, October 29

- Sara Hamilton and other industry leaders will identify future opportunities and challenges for family enterprises
- A sixth generation governance and business succession story will feature the Bemberg family enterprise
- Pencils of Promise founder Adam Braun will share his story. He has built over 200 schools globally.
- Peer Dialogue opportunities will provide discussions unique to each peer community
- Eight breakout sessions will offer a variety of targeted learning experiences

Social Event: An evening of celebration at the renowned **Field Museum of Natural History**, with access to several key exhibits for the inquisitive mind.

Thursday, October 30

- Noted demographer Neil Howe will lead attendees through generational patterns that influence future trends
- The FOX research team and several Thought Leaders will share insight into the impactful Client of the Future
- A panel will address the perceptions and realities of the conversation on issues of economic inequality
- Program adjourns at 2:00pm

Palmer House Hilton, Chicago

FOX Fall Forum Headquarters will be at the recently renovated Palmer House Hilton Hotel, founded by the Potter Palmer Family in 1871.

Please mark your calendar now. Registration materials will become available in late July.

Keep up to date with this and other upcoming FOX events at: *https://www.familyoffice.com/learning-events.*

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Advent provides technology solutions for family offices around the world, including:

- **Portfolio Management, Accounting and Reporting:** We offer a variety of solutions for different types and sizes of firms, with different business needs, budget levels, and in-house IT capabilities.
- **Trading:** Our trading platform gives portfolio managers and traders visibility and control across the trading process, from decision through settlement.
- **Client Relationship Management:** Our solutions help you know your clients better and deliver more responsive service.
- **Research Management:** Our research management solution centralizes and organizes all your research data in one place, so you can do more thorough due diligence in less time.

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- **Scalability:** All of our platforms are highly scalable by design. No matter how much you grow, you'll never outgrow Advent.
- **Transparency and Accuracy:** Our solutions enable you to make informed decisions based on easily accessible and reliable data.
- **Regular Upgrades:** We make it easy to upgrade at predictable intervals, so you can reap the benefits of the latest functionality as it becomes available.

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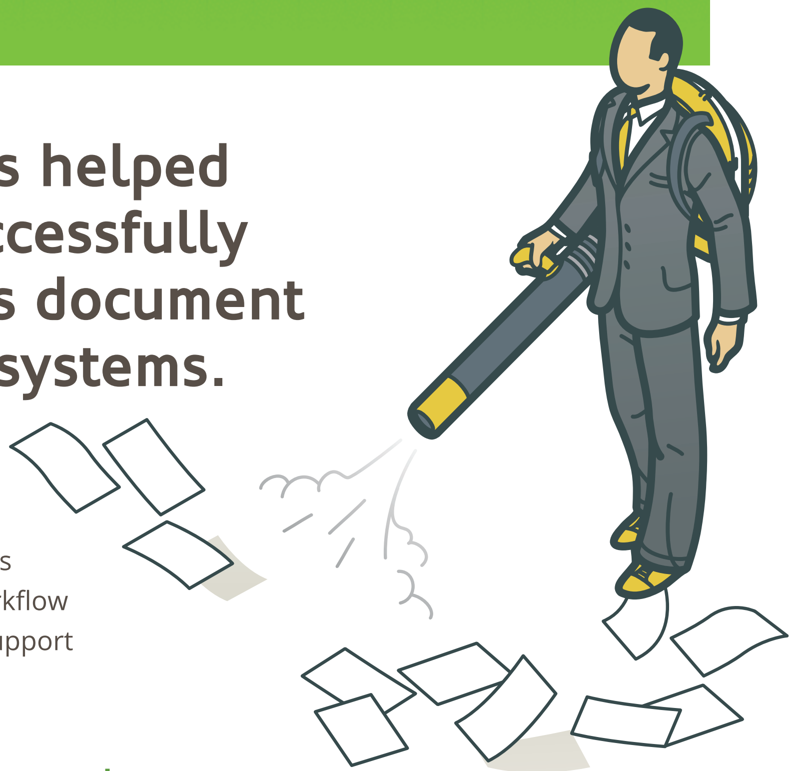

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We take pride in the fact that our clients consider Cabinet more than just a vendor. We've become a trusted advisor to innovative businesses that are seeking the security, savings and flexibility of a paperless office. When you purchase or subscribe to one of our products, you get more than an outstanding document management software solution. You get Cabinet – our people, our experience, our expertise, our training — and our values.

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We even hold a popular annual conference, allowing clients to learn from the experts and see innovative, new ways to use our document management software suite. The goal? A shallow learning curve, 100 percent user adoption – and maximum client ROI.

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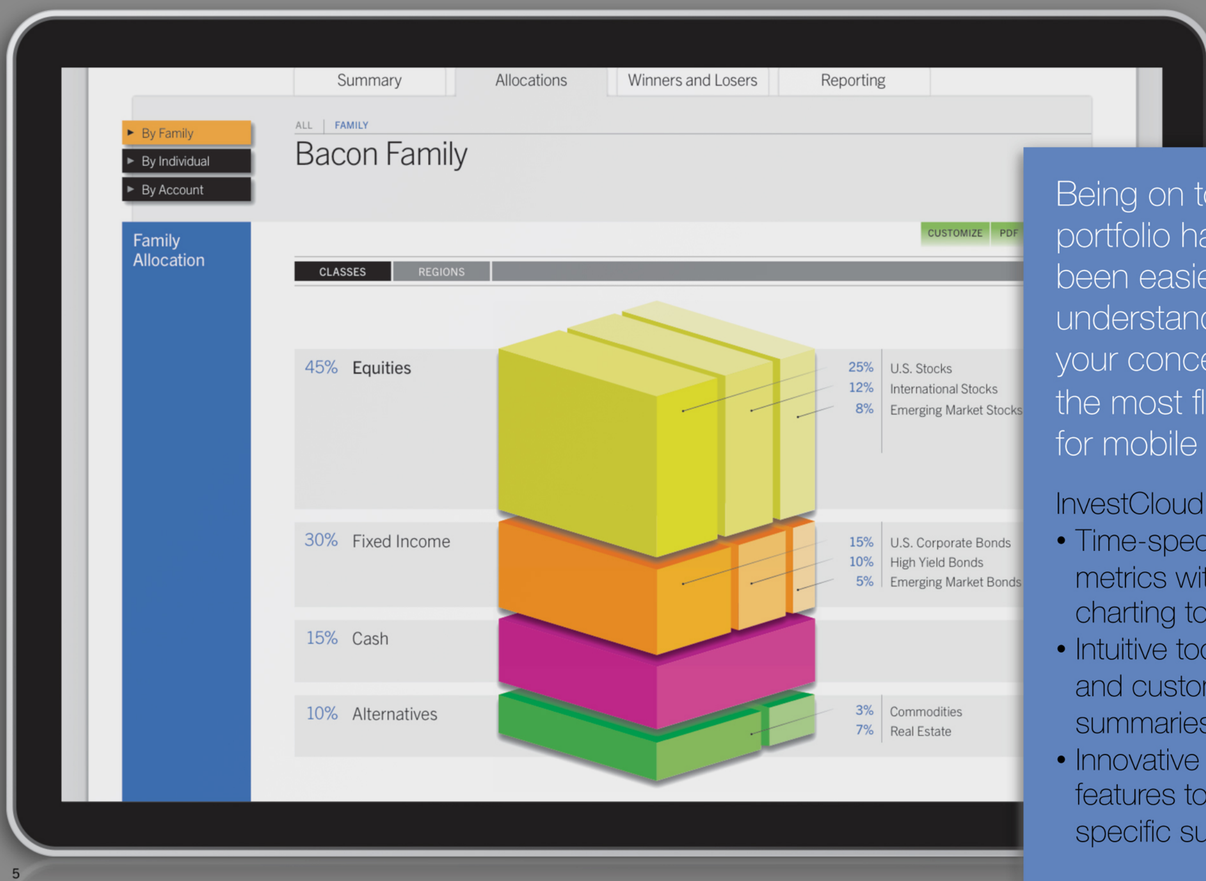

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Designed, Built and Run in the USA

Who We Are

Founded in 1889 and undiluted by merger or acquisition, Northern Trust has earned distinction as an industry leader combining exceptional service and expertise with innovative capabilities and technology. We are a leading provider of asset servicing, fund administration, asset management, fiduciary, and banking solutions for wealthy families, individuals, family offices, corporations and institutions worldwide. A financial holding company headquartered in Chicago, Northern Trust serves clients in more than 40 countries from offices in 18 U.S. states and 18 international locations in North America, Europe, the Middle East, and the Asia-Pacific region. Our mission is to serve as our clients' most trusted advisor, enabling them to achieve their financial goals by providing them with comprehensive advice and solutions. As befits our fiduciary heritage, we strive to win their loyalty by always acting with the highest integrity, working tirelessly for their best interests, and by creating an extraordinary client service experience in all our interactions with them.

What We Do For Family Offices

Northern Trust's Global Family and Private Investment Office Group is a dedicated practice within one of the world's most highly rated and stable financial institutions. For more than 30 years, our focus has been to provide relationship excellence by delivering proven investment, fiduciary, financial reporting, banking and advisory solutions to the wealthiest of private clients and to their family offices, businesses, charitable entities and advisors worldwide. We foster long-term relationships by offering a unique combination of service, expertise and global capabilities which are tailored to the distinct needs of our clients.

What's Special About Northern Trust's Global Family Office Practice?

Northern Trust's understanding of the distinct needs of wealthy families and the family offices, private trust companies and private investment companies is truly unique. What differentiates our practice area further includes the following:

- *A Global and Dedicated Practice*. Northern Trust has been serving family offices since the early 1980s. Today, the group has more than 260 Northern Trust professionals who are situated in North America, Europe and the Middle East and are serving the needs of nearly 400 families whose personal, charitable, corporate and operating activities are in more than 25 countries around the world.
- *Focus on Client Service Excellence*. According to our most recent Client Relationship Survey, nearly 95% of our Global Family Office clients have shared that they were either highly satisfied or satisfied with their relationship with Northern Trust. Some factors driving this performance include our 125 year fiduciary heritage, our uncompromising commitment to the family office business and the wide-range of resources available to serve the needs of our clients.
- *Balanced Delivery of Both Private Client and Institutional Client Solutions*. Northern Trust balances the availability of both private banking and institutional capabilities to our Global Family Office clients. We offer a broad range of investment advisory, asset management, global asset servicing, commercial banking and trade execution solutions and couple those with our contemporary trust, sophisticated credit, private banking and family advisory services. Delivering both our private client and institutional capabilities under a focused family office servicing framework ensures that our clients' needs are truly met.
- *Peer Networking and Education*. Beyond product and service, Northern Trust's Global Family Office practice commits considerable resources, time and energy to client development activities such as peer networking, education and family office advisory programs. Throughout the year we selectively orchestrate these highly focused sessions across the United States and internationally. These sessions are intended to provide an opportunity for our clients and advisors to learn from one another, promote industry leadership and inform Northern Trust as to how we can better serve the requirements of our clients.

For more information about how we can help you, contact:

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July 2014

Outsourced Private Wealth Aggregation and Custom Reporting

Private Client Resources (PCR), founded in 2000, is an industry-recognized client reporting and aggregation expert with unique end-to-end capabilities:
- Comprehensive investment data aggregation
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- Enterprise, expert and custom support services

> Why 6 of the 10 leading private banks, and premier RIAs and family offices chose PCR:
- Aggregation and reporting expertise with tailored services
- PCR does the work
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- Award-winning reporting platform

> $96+ Billion in aggregated account value, of which $27 Billion are alternative investments

> Awarded: PAM "Best Reporting Solution" in 2014 and "Most Innovative Private Bank Provider" in both 2013 & 2012; Family Office Review "Best Family Office Technology Provider" in 2013

> 10+ business partners signed onto platform, including Hedge Fund Research, StatPro, Argus Research, eMoney and Salesforce.com

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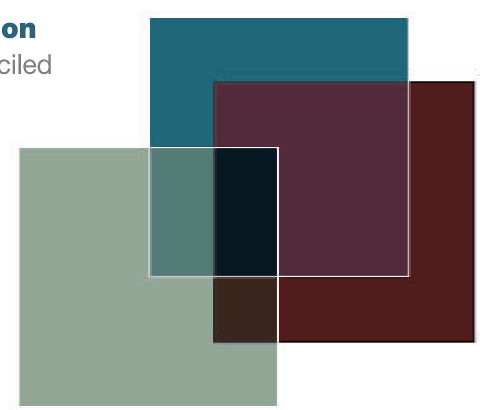

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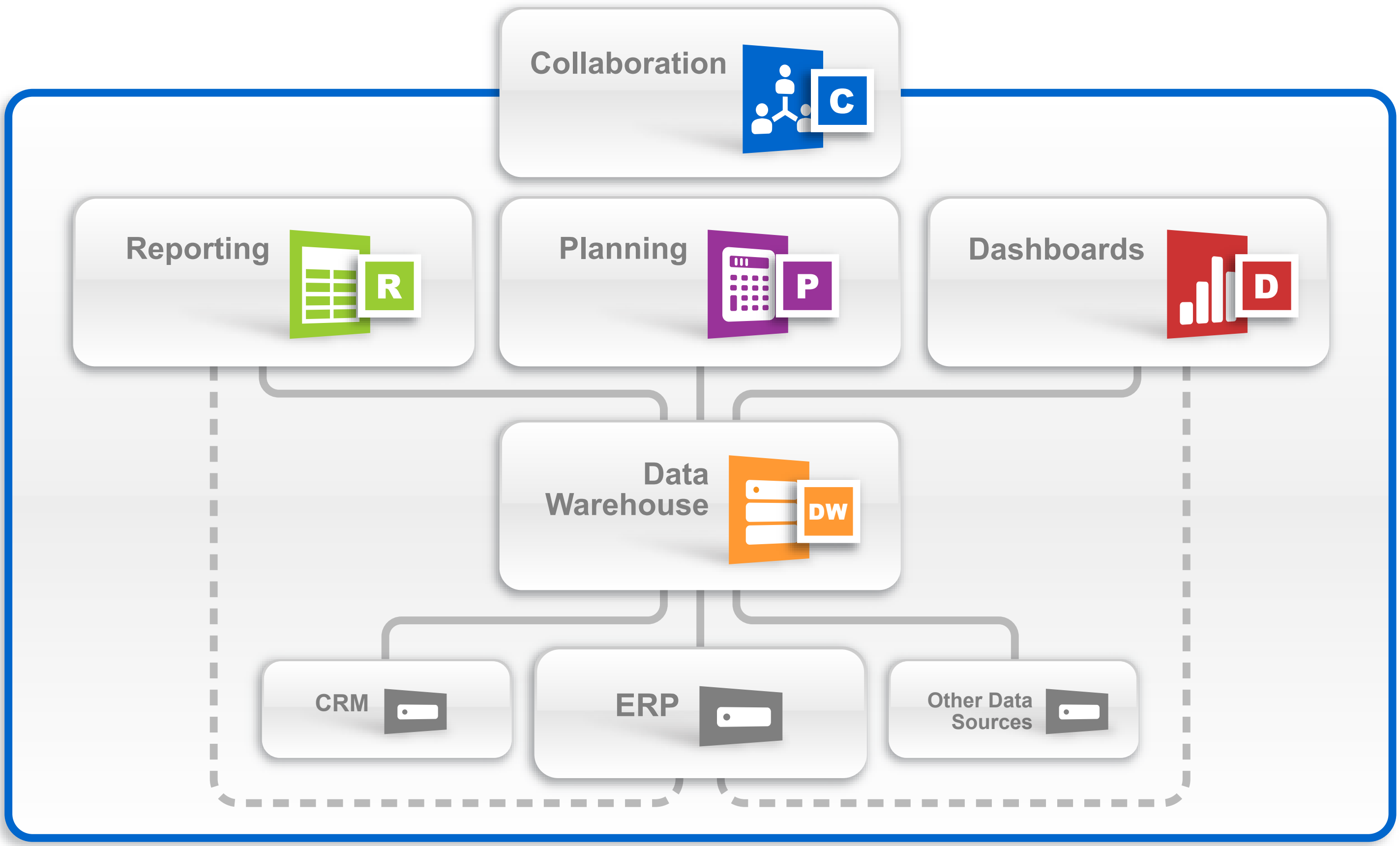

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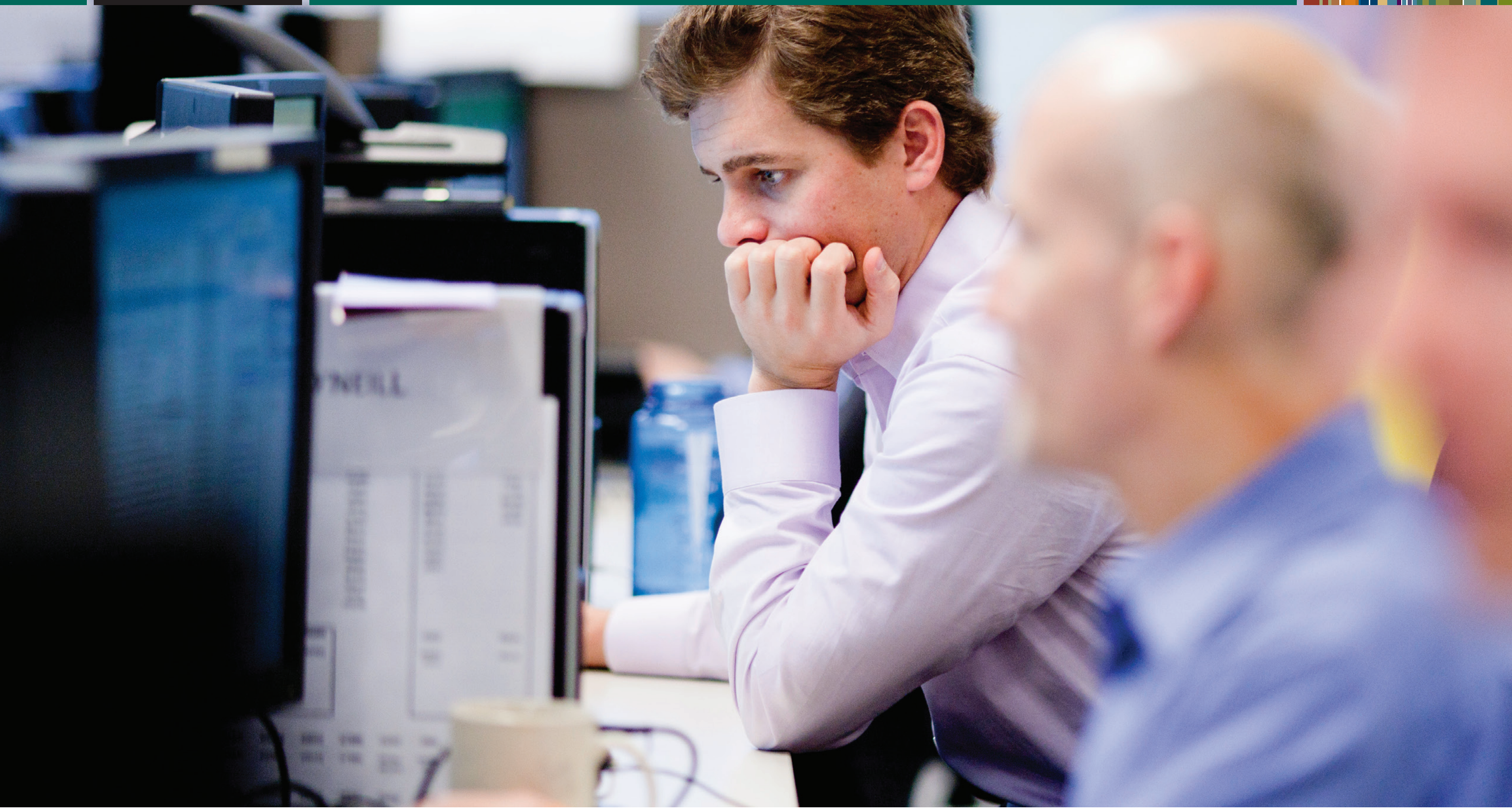

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