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TAX PLANNING WITH INVESTMENT COMPANIES

March 29, 2011

Dear Clients and Friends:

Recent changes to the wealth transfer tax laws have enhanced the appeal of lifetime transfers to grandchildren. This newsletter discusses these new laws and the use of a family investment company as a vehicle for those transfers.

The three components of the federal wealth transfer tax system are the gift tax, estate tax, and generation-skipping transfer tax ("GST tax"). The GST tax is separate from the estate and gift tax. The GST tax imposes a transfer tax on family assets at least once each generation, so that assets that escape estate or gift tax when they pass from one generation to the next may still be subject to GST tax. Nevertheless, the GST tax may be imposed on a transfer that is also subject to estate or gift tax. For example, if a transferor gifts assets directly to a grandchild, those assets will be subject both to gift tax and to GST tax.

The 2010 Tax Act lowered the current GST tax rate to 35%, although in the past the GST tax rate has been as high as 55%. To mitigate the burden of the GST tax, every individual is allowed an exemption from that tax ("GST exemption"). Effective utilization of the transferor's GST exemption can shield assets from the

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GST tax and reduce the future estate tax imposed on the family assets. The recent legislation increased the current GST exemption to $5.0 million, subject to an adjustment next year for inflation. A married couple may shelter twice as much as an individual because each spouse has a separate GST exemption.

The 35% rate and $5.0 million exemption are effective for years 2011 and 2012 and are scheduled to expire after December 31, 2012. No one can predict what federal transfer tax rates and exemptions will apply beginning in 2013.

A family investment company may provide a vehicle to "leverage" the increased GST tax exemption and thereby enhance generation-skipping planning. The family investment company would be organized as a limited partnership or limited liability company (LLC). Either vehicle would have an agreement that would govern the management and liquidation of ownership interests. Senior family members would transfer a portion of their assets to the investment company and then transfer minority interests in that company as part of their GST planning. Federal transfer tax law allows valuation adjustments (or "discounts") to reflect the downward effect on value that arise from restrictions inherent in owning a minority interest in a closely-held, non-publicly traded family company. The leverage caused by these adjustments enhances generation-skipping planning.

This technique requires that the senior generation-founders must have a *significant nontax purpose* for creating the new company. The taxpayer must have a reason other than seeking valuation adjustments attributable to the restrictions in the operating agreement. Family members who actively manage their investment portfolio may assert several nontax purposes for forming an investment company: keeping assets within the family; allowing investment activities to be managed as a joint enterprise; providing some protection from future creditors; and providing continuity of management in the event a senior family member retires from managing the company portfolio. These nontax purposes would be strengthened by company management implementing a specific investment strategy and documenting that strategy in an Investment Policy Statement.

One recent federal Tax Court case sustained the leveraging of transfers of interests in a partnership that was formed and funded with a securities portfolio because the senior family member wanted to use the investment company to perpetuate his investment strategy. The evidence in the case showed that the decedent was not a passive investor, but actively analyzed and managed his portfolio. That case provides guidance as to the evidence that will support a significant nontax purpose.

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The significant nontax purpose rule applies to formation and to operation of the investment company. The tax effects of transfers of interests in a business may be lost if the owners commingle company assets with personal funds or if the company is not operated as an independent business. Improperly crafted restrictions in the governing agreement also may defeat desired tax effects. The Internal Revenue Code has a separate chapter dedicated to disregarding improper operating agreements when valuing gifts of minority or restricted interests in family controlled entities.

Recent legislation has added a provision to the tax law providing that a transaction or activity has "economic substance" only if the transaction meaningfully changes the taxpayer's economic position *and* the taxpayer has a substantial (nontax) purpose for the transaction. If the transaction has no economic substance, it has no effect for tax purposes. This new law reflects heightened scrutiny of intra-family transactions, including generation skipping planning, to determine whether a significant nontax purpose exists.

The increased GST exemption, the recent court decisions, and the new legislation increase the opportunities and challenges for using family investment companies in wealth transfer planning. The business must be properly formed and operated, but the economic effectiveness of this technique remains appealing.

Please feel free to call on us if you wish to discuss this planning in further detail.

Very truly yours,

JOHN A. HARTOG, INC.