

Updated guidance to tax and
wealth planning in 2011
*Addressing opportunities
within new tax act*



Introduction

Since the publication of *The 2011 essential tax and wealth planning guide: A year-round resource for managing in uncertain times*, we have received a temporary answer to some of the major tax and wealth planning questions that had been in front of us. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act), which became law on December 17, 2010, is the product of a compromise forged between the President and Congressional Republicans. In addition to addressing the Bush-era income tax cuts, the Act also includes temporary extensions of unemployment insurance benefits and dozens of temporary business and individual tax incentives, including significant new (not extended) transfer tax benefits.

The Act provides a significant opportunity for individuals and private enterprises to execute — with more certainty — short-term tax planning and wealth transfer strategies before 2013.

Using this addendum

This publication provides important updates to *The 2011 essential tax and wealth planning guide: A year-round resource for managing in uncertain times*, including information for individuals and private enterprises on how the Act impacts wealth and tax planning. The primary focus for individuals should be short-term planning as we prepare for possible increasing income and transfer tax rates in 2013.

Two sections of the Guide are impacted by provisions within the Act:

Wealth transfer tax: The first section of this addendum, *Overview of the transfer tax provisions of the 2010 Act*, describes opportunities now available for wealthy individuals and families to consider for transferring wealth. This section replaces the *Wealth transfer tax* section of *The 2011 essential tax and wealth planning guide*.

Income tax: The second section of this addendum, *Individual income tax relief*, presents new information on managing income tax in a short-term planning environment. This section replaces the subjects of *Recently enacted tax law changes affecting individuals*, *Tax rates*, and *alternative minimum tax* within the *Income tax* section of the Guide.



Overview of the transfer tax provisions of the Act

Prior to the Act, for 2010 only, the gift tax rate had been reduced to 35%, the estate tax had been repealed, and no generation-skipping transfer (GST) taxable event could occur in 2010; but the GST tax itself had not been repealed as the estate tax had. The Act, subject to the exception noted below, reinstates and modifies the estate and GST taxes **retroactively** to the beginning of 2010, and, quite unexpectedly, favorably modifies the gift tax beginning in 2011.

Until the Act, Congressional inaction and the resulting uncertainty with respect to transfer taxes in 2010, (particularly the uncertainty surrounding whether or not Congress would retroactively reinstate the 2009 transfer tax regime and its higher 45% top tax rate), had paralyzed many taxpayers and their advisors. Furthermore, many rules in the estate, GST, and gift tax areas were drafted with the expectation that the transfer tax regime would continue without interruption, and did not adequately take into account a situation in which the estate and GST taxes would be “suspended” for a year. The Act removes most of the impediments to transfer tax planning and removes the issues arising from the lack of continuity in the estate and GST arenas that prevailed in 2010 under prior law.

Of course, one should never forget that state estate and/or inheritance taxes may be applicable notwithstanding the new favorable federal transfer tax developments and, in many cases, state taxes are not affected either directly or indirectly by changes in federal law. Merely because a federal tax will not arise does not mean, for example, that an estate will not bear state estate or inheritance taxes.

New estate tax regime

Under the Act, the estate tax regime is retroactively reinstated from the beginning of 2010 with a \$5 million exclusion amount per decedent and a top rate of 35%. Beginning in 2011, the estate and gift tax regimes are reunited with a common \$5 million exclusion amount and a top rate of 35%. The exclusion amount will be indexed for inflation, beginning in 2012. To the extent a taxpayer uses his or her exclusion for lifetime gifts, the amount available for use against the estate tax is reduced.

In its simplest manifestation, the taxable estate is determined by taking the aggregate value of all includible assets, reduced by all allowable exclusions and deductions, and increased by

the taxable gifts made by the decedent after 1976. A tentative tax is then computed on the taxable estate. Assuming no prior gift tax was actually paid, this tentative tax is then offset by the applicable credit amount. For 2011, that amount is the estate tax on the \$5 million base exclusion amount, computed using the rate structure in effect on the date of death (\$1,730,800 in 2011, and the number will be slightly larger in 2012 because the exclusion amount is indexed for inflation). Any estate where the tentative tax is less than the applicable credit amount generally will not be subject to any federal estate tax.

Where gift tax was actually paid on prior gifts, an additional credit will be allowed for some or all of the gift tax actually paid. The effect of this credit is to permit those that have made gifts in excess of past exclusion amounts to take advantage of the additional \$4 million increase in the exclusion amount provided in the Act. The Act makes it clear that this credit is a hypothetical amount determined using the rate structure existing at the date of death, but taking into account the applicable credit amount at the date of gift. In 2011 and 2012, when the top estate tax rate is 35%, the limitations on the credit amount will result in a credit less than the amount of gift tax actually paid when the top gift tax rates were greater than 35%. Interestingly, the opposite may be true in 2013 if the top rate returns to 55%.

Although the law is ambiguous on how the credit should be computed after the top rate escalates and the applicable credit amount declines, in such a setting the credit computation can be interpreted to allow a credit greater than the amount of tax actually paid for taxable gifts made in those years in which the top gift tax rates were less than 55% and/or when the applicable credit amount was greater than \$345,800 (the amount of tax on the \$1 million gift exclusion amount that is anticipated under the 2013 rules as they now exist).

Some credibly argue that granting a credit in excess of the applicable credit amount when no tax liability was actually paid is an unlikely outcome; but, to interpret the language otherwise would imply that the \$5 million exclusion amount permits only a deferral of tax which will be recouped as transfers (during life or at death) occur after 2013. Such an interpretation would appear to defeat the intent of the legislation. See Planning tip #1 in the *Gift tax* section for further consideration of this issue.

The Act now allows portability of the unused \$5 million exclusion amount of decedents dying in 2011 and 2012 to surviving spouses. Thus, a surviving spouse could use his or her own base exclusion amount of \$5 million plus the unused exclusion amount of his or her most recent deceased spouse to offset the tax on subsequent gifts or to offset his or her estate tax. The decedent's unused exclusion amount will not be available to the surviving spouse unless the executor of the deceased spouse's estate makes an election to convey it and computes the amount to which the surviving spouse is entitled. Relief will not be permitted to an executor who fails to make a timely election. In enforcing the carryover, the IRS is permitted to review the deceased spouse's prior filed gift tax returns and estate tax return to determine the proper unused exclusion amount, notwithstanding the statute of limitations with respect to those returns may have closed. Additionally, the Act gives the IRS broad regulatory authority to provide future guidance on this provision.

The Act grants extensions of time for the filing of the estate tax return for certain 2010 estates, making tax payments with respect to those estates, and making a disclaimer with respect to an interest of property passing by reason of the death of certain decedents. In the case of an estate of a decedent dying after December 31, 2009, and before December 17, 2010, the due date for these requirements will be September 17, 2011. Estates of those dying between December 17, 2010 and January 1, 2011 are subject to the normal compliance deadlines.

Planning tip # 1: Review wills and revocable trust agreements. The portability provisions represent a development that could greatly simplify the tax planning that must occur before or upon the death of the first spouse to die. No longer will it be necessary to make sure that both spouses have at least enough property to fully utilize the decedent's \$5 million exclusion. Even where each spouse individually controls assets in excess of \$5 million, the need to affirmatively plan for its use in the testamentary plan of the first spouse to die is removed (unless that spouse desires to affirmatively use his or her GST tax exemption, which, as is discussed below, is not portable). In fact, subject to the GST tax exception just noted (and ignoring state estate/inheritance tax considerations), there would now appear to be no detriment to a classic "sweetheart" disposition — leaving one's assets fully to one's surviving spouse either outright or in trust.

Planning tip # 2: The concerns that once existed regarding the interpretation of tax-sensitive funding clauses in the disposition provisions of an estate plan in a year in which the estate tax was repealed have now disappeared. For example, assume your net worth is \$10 million. If a credit shelter trust (a trust specifically created to use the applicable exclusion amount, sometimes also called a bypass trust) is to be established and funded upon your death for the benefit of your children, and your will states that the trust should be funded with the maximum amount that does not generate any estate tax with the remainder over to the surviving spouse, you would now leave (assuming no prior taxable gifts) \$5 million in trust to your children and \$5 million to your surviving spouse.

Many feared that such a provision in a year in which the estate tax was repealed (e.g., 2010 prior to the Act) would cause the entire estate to pass in trust for the children and none to the surviving spouse. The question now is whether the surviving spouse will have access to sufficient assets if as much as \$5 million (indexed for inflation) were to pass in trust for the children. If leaving more to the surviving spouse is desirable, portability makes it possible for the first time in transfer tax history to avoid any federal estate tax detriment from having less than \$5 million pass in trust to the children with the remainder to the surviving spouse.

On a cautionary note, many states do not now and will not hereafter conform to the federal estate tax rules. As a consequence, an immediate state estate/inheritance tax may arise where the federal exclusion amount exceeds the corresponding state exclusion amount and the entire federal exclusion amount is fully utilized; or, alternatively, as explained more fully below, the failure to use a state's exemption amount may very well result in a greater state estate/inheritance tax upon the death of a surviving spouse.

Planning tip # 3: Unfortunately, under current law, portability will benefit only the surviving spouses of those that die in 2011 and 2012. For portability to be made permanent, subsequent Congressional action will be required. Consequently, testamentary documents must remain sensitive to a possible return to pre-portability law.

Prior to the Act, a simple estate plan under which everything passed to the surviving spouse, while always

eliminating any federal and state estate tax in the estate of the first to die, gave rise to a risk that additional taxes may be due at the death of the surviving spouse — taxes that could have been avoided had the estate plan been designed to take full advantage of the credits and exemptions available to the estate of the first spouse to die. To increase the effectiveness of an estate plan, the will or revocable trust could be designed to leave all assets to the surviving spouse except for the applicable exclusion amount. This amount would go into a credit shelter trust for the benefit of the spouse and family. Under such a plan, the spouse would benefit from the entire estate, but the credit shelter trust assets would not be included in his or her estate on his or her death. Such plans were commonly encountered prior to the Act. As noted above, differing federal and state exclusion amounts will complicate this planning and may require the payment of some state estate/inheritance tax by the estate of the first spouse to die.

Planning tip # 4: Should a surviving spouse be the object of a portability election, the Act is clear that the deceased spousal unused credit amount is available to offset both the survivor's gift and estate taxes. Given the possibility that portability may expire January 1, 2013, prudence would dictate that any unused exclusion amount be used prior to that date.

Some estates can elect former 2010 law

The Act allows the estates of decedents dying on or after January 1, 2010, and before January 1, 2011, to elect out of the Act's estate tax regime and instead apply former 2010 law, which substituted the modified carryover basis rules for the repealed estate tax. The election, once made, would be revocable only with the consent of the Secretary of Treasury. The Act instructs the Secretary of Treasury to provide guidance regarding how and when the election is to be made. As of the date of publication, the IRS has yet to release the necessary guidance regarding how the modified carryover basis rules are to be elected and implemented. For beneficiaries of those estates making the election out of the retroactive estate tax and into the modified carryover basis rules, assets inherited from a 2010 decedent will generally bear the same basis as the decedent had in the asset prior to death, with certain modifications. If the inherited asset had a fair market value on the date of death that was less than the decedent's basis in that asset (i.e., a

"built-in loss" asset), the basis will be reduced to the fair market value of the asset on the date of death.

The modified carryover basis rules also prescribe a limited basis increase to be allocated by the executor to appreciated assets of the estate. Under this provision, for an asset passing from the decedent to the successor in interest, the basis to the successor includes not only the decedent's basis in the appreciated asset, but also that amount of the decedent's "basis increase" adjustment which the executor allocated to it, with an asset's new basis limited to its fair market value on the date of death.

The maximum allowable "basis increase" adjustment that may be allocated among appreciated assets by the estate is equal to \$1.3 million plus:

- 1) any capital loss and net operating loss carryovers not utilized in the decedent's final income tax return, and
- 2) the aggregate "built-in loss" in the trade, business, or investment assets of the decedent just prior to the death of the decedent (i.e., the sum of the amount of any losses that would have been allowable if the trade, business, or investment property had been sold at fair market value immediately before the decedent's death).

In addition, a special \$3 million "spousal property basis increase" adjustment is available for appreciated assets inherited by a surviving spouse. For an asset to qualify for an allocation of the spousal property basis increase adjustment, it must have been owned, in whole or in part, by the decedent at the date of death, or been an asset of a revocable trust established by the decedent. Relatively speaking, this is a much more limited class of assets than that which receives a step-up in basis under the estate tax regime.

The carryover basis regime is complex in both comprehensibility and calculation; therefore, planning for the assignment of the basis increase adjustments to qualifying assets should be done carefully. From a tax-only perspective, the appreciated assets that should attract a basis increase allocation are those where the basis increase is most likely to yield an income tax benefit most quickly. For example, assets qualifying for current depreciation, depletion, or amortization are generally better candidates than assets that are likely to be retained by the family as heirloom assets across generations. The current income tax profiles of the heirs may also inform the allocation process. Though the

responsibility for the allocation of the basis increase adjustments lies with the executor or trustee, consultation with the heirs' tax advisors is highly recommended.

Planning tip # 1: While common sense would appear to dictate that the estates of 2010 decedents where the sum of the gross estate and the decedent's adjusted prior gifts is in excess of \$5 million would universally elect out of the estate tax, such a conclusion is not always justified. What complicates the analysis is that under the Act, the top income tax rate and the top estate tax rate are both set at 35%; and, income tax rates are set to rise after December 31, 2012.

Thus, in limited situations where carryover basis would appear to leave the successors in interest at risk for significant future ordinary income that might be taxed at greater than 35%, perhaps remaining within the 35% estate tax may yield a better overall economic result. Such limited situations might include estates that own partnership interests having large negative capital account balances; or, depreciated assets subject to large recapture obligations such as improved real property or oil and gas interests, and so on. These and analogous situations may give rise to an income tax liability greater than the corresponding estate tax liability, particularly if state income taxes apply or if the income is triggered in years after 2013, when the top income tax rate is anticipated to increase either because of the sunset of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) or the instigation of the 3.8% unearned income Medicare tax.

Similarly, where the full step-up in basis provided by the estate tax could give rise to immediate income tax savings at rates higher than 35% (for example where the estate or the estate's beneficiaries reside in states having higher income tax rates) paying the estate tax may provide for an overall better outcome. This situation might arise, for example, with estates that consist of significant interests in property that can be depreciated, amortized, or depleted.

The likelihood of the estate tax giving rise to an overall tax savings may be dramatically increased if a significant portion of the estate tax can be deferred, for example, under the installment payment rules in place for small businesses. Of course, time value of money considerations play a role in any of the analyses described above.

An additional complicating factor is the cash flow impact where the federal election out of the estate tax and into the modified carryover basis rules takes place in a state where a state estate/inheritance tax remains in force. Specifically, while state estate/inheritance taxes are deductible for purposes of determining the federal taxable estate, they are not deductible for federal or state income tax purposes. Some states' laws will support a conclusion that the income tax basis of assets for state income tax purposes is stepped-up to fair market value by virtue of being subject to the state's estate/inheritance tax. If this is the case, then federal and state income tax basis will diverge, with attendant bookkeeping complications.

Miscellaneous

The Act also extends through 2012 several modifications enacted as part of EGTRRA. These include:

- Expanding the availability of installment payments for estates with interests in a qualified lending and finance business.
- Clarifying installment payment qualifications requiring that only the stock of the holding companies (not that of operating subsidiaries), must be nonreadily tradable. (Estates taking advantage of either of these two provisions would have to make the required payments over five years rather than 15.)
- Expanding the availability of estate tax installment payments by broadening the definition of an interest in a closely held business (i.e., a business with 45 or fewer owners rather than 15 or fewer owners).
- Allowing an estate tax deduction of estate/inheritance taxes paid to any state or the District of Columbia for decedents dying after December 31, 2009.

The income tax basis of inherited assets

The modified carryover basis rules that, prior to the Act, had applied to all assets inherited by reason of a 2010 death were retroactively repealed and the historical rule of inherited assets generally taking an income tax basis equal to their respective fair market values at the date of death was retroactively reinstated. As under prior law, this step-up is not available for deferred income assets, including, but not limited to, installment notes receivable, deferred compensation plans, qualified retirement plans, and regular IRAs.

Gift tax

As a quick overview, most gratuitous transfers of property during life are subject to the federal gift tax. Connecticut and Tennessee also assess a gift tax at the state level. The gift tax is computed based on the fair market value of the property transferred. Some types of transfers are excluded in determining the total amount of gifts that are subject to tax. For example, in 2011, gifts by individuals of up to \$13,000 per recipient are generally covered by the gift tax annual exclusion and are not subject to gift tax. The annual exclusion is adjusted for inflation in increments of \$1000.

To qualify for the gift tax annual exclusion, gifts must be of a present interest. A present interest implies that the beneficiary has a substantial present economic benefit arising from the gift property. Such a benefit implies that the assets received can be readily converted to cash or that the assets received are income producing from the outset. Consequently, not all outright gifts will qualify for the gift tax annual exclusion. Transfers under the Uniform Transfer to Minors Act and funds contributed to Section 529 educational savings plans will generally qualify for the gift tax annual exclusion. Certain gifts in trust also qualify if the trust vests an income interest in the beneficiary or allows the beneficiary a choice between withdrawing some or all of the value of the gifted property or leaving it in the trust.

Transfers to a spouse who is a U.S. citizen are covered by the unlimited marital deduction; therefore, such transfers may be made totally free from gift tax. If your spouse is not a U.S. citizen, then the amount that can be transferred to your spouse free of gift tax in 2011 is \$136,000. If either you or your spouse is not a U.S. citizen, it is imperative that you make your estate planning advisor aware of this fact.

In addition to the \$13,000 annual exclusion (and the \$136,000 annual exclusion for a noncitizen spouse), every individual taxpayer can transfer a certain amount of property during his or her lifetime without paying gift tax. As was discussed above, the amount of property that can pass tax free is referred to as the applicable exclusion amount. The applicable exclusion amount, as was discussed above, is used to calculate the credit available to offset the gift tax calculated on the aggregate of all current and prior taxable gifts. The applicable exclusion amount for lifetime gifts was \$1 million in 2010.

Significantly, and unexpectedly, the Act reunified the estate and gift tax exclusion amounts at \$5 million for transfers made after December 31, 2010. The top gift tax rate was 35% in 2010 (the lowest such rate since 1975), and the Act preserves the 35% maximum rate through 2012. Notably, under the law as now written, the \$5 million exclusion amount will return to \$1 million and the top rate will return to 55% from its present 35% on January 1, 2013. What cannot be overemphasized is that the failure to utilize the full \$5 million exclusion amount prior to its lapse in 2013 may result in the unused amount being subject to estate or gift tax at higher rates at some subsequent date. Absent one or more compelling nontax reasons, failing to avail one's self of the transfer tax benefits of the Act may result in an economic detriment to the family. See Planning tip #1 below.

For taxpayers who have previously made substantial taxable gifts, an additional credit is allowed for some or all of the gift tax actually paid in the past. The effect of this credit is to permit the taxpayer to take advantage of the additional \$4 million increase in the exclusion amount provided in the Act. As is the case with the estate tax, the Act makes it clear that this credit is a hypothetical amount determined using the rate structure existing for the year in which the credit is being computed (i.e., 2011 for gifts made in 2011), but taking into account the applicable credit amount in effect at the date the prior gifts were made. In 2011 and 2012, when the top gift tax rate is 35%, the limitations on the credit amount will result in a credit less than the amount of gift tax actually paid when the top gift tax rates were greater than 35%. Interestingly, as was previously observed, the opposite may be true in 2013 if the top rate returns to 55%.

Although the law is ambiguous on how the credit should be computed after the top rate escalates and the applicable credit amount declines, in such a setting the credit computation can be interpreted to allow a credit greater than the amount of tax actually paid for taxable gifts made in those years in which the top gift tax rates were less than 55% and/or when the applicable credit amount was greater than \$345,800 (the amount of tax on the \$1 million gift exclusion amount that is anticipated under the 2013 rules as they now exist).

Some credibly argue that granting a credit in excess of the applicable credit amount when no tax liability was actually paid is an unlikely outcome; but, to interpret the language otherwise would imply that the \$5 million exclusion amount permits only a deferral of tax which will be recouped as transfers (during life or at death) occur after 2013. Such an interpretation would appear to defeat the intent of the legislation.

Planning tip # 1: For ease of illustration and computation, consider a single taxpayer with an estate, on December 31, 2012, of \$8 million. Based on his individual circumstances, he determined to take partial advantage of the \$5 million exclusion amount, by making a \$2 million gift in 2011. (Again, for ease of illustration, we will ignore the 2012 inflation adjustment to the \$5 million exclusion amount.)

Assume that the taxpayer died unexpectedly in 2013 and that the exclusion amount is then \$1 million and the top tax rate 55%. The taxpayer would have a taxable estate of \$10 million (\$8 million estate at death plus \$2 million of adjusted taxable gifts). Based on the likely mechanics of the Act after it sunsets, the computed tax with a top rate of 55% would be \$5,140,800 reduced by the 2013 unified credit amount (\$345,800) and less the hypothetical credit on the adjusted taxable gifts in excess of the unified credit amount (\$435,000) — for a total tax of \$4,360,000.

Assume the taxpayer had made an additional \$3 million gift in 2012, which completely absorbed his remaining \$5 million exclusion amount. The taxpayer would still have the same taxable estate of \$10 million (\$5 million estate at death plus \$5 million of adjusted taxable gifts). Based on the likely mechanics of the Act after it sunsets, the computed tax with a top rate of 55% would be the same \$5,140,800 reduced by the 2013 unified credit amount (\$345,800) and less the hypothetical credit on the adjusted taxable gifts in excess of the unified credit amount (\$2,045,000), for a total tax of \$2,750,000. By virtue of having used the full \$5 million exclusion amount, the taxpayer's heirs would have \$1,610,000 more than they would have otherwise enjoyed — an increase in their inherited wealth of 33%.

In the interest of full disclosure, as was discussed above, there are those that question the availability of a credit where no tax was actually paid. Thus, according to those

holding this opinion, the estate tax in both scenarios would be the same — \$4,795,000 — because the only credit available would be the applicable credit amount in 2013 — \$345,800. Subject to future guidance, given the legislative history, we do not share this more conservative interpretation of the rules.

Finally, the Act retroactively repeals certain rules used for determining whether a 2010 gift to a nongrantor trust would be considered incomplete, and therefore not subject to gift tax. As a result, the pre-existing rules for determining whether a gift is complete, and subject to current tax, will apply.

Gift tax – what wasn't included in the Act

Unlike previous estate tax proposals introduced and defeated in the Senate in 2010, the Act does not include a provision that would require a 10-year minimum term for grantor retained annuity trusts (GRATs). A GRAT is a trust that names the grantor as its sole beneficiary during a set period of years during which the trust is required to make an annuity payment to the grantor. The annuity amount, as a function of prevailing interest rates, is set at a level where the net present value of the aggregate annuity payments is nearly 100% of the value of the property contributed to the trust. If the assets consistently outperform the prevailing interest rate, then the remainderman of the GRAT will succeed to that excess. Since the grantor only parts with the value of the remainder, the gift tax cost of a GRAT is nominal. However, because the trust is established fundamentally for the grantor's benefit, should death occur during the annuity period, the full value of the trust, as a general rule, will be included in the grantor's gross estate. It is for this latter reason that a 10-year minimum term will dramatically affect the appeal of GRATs as estate planning vehicles.

Even though Congress did not approve changes to the use of GRATs as part of the Act, the window for using an annuity term of less than 10 years could still close in the future. Also keep in mind that current conditions favoring the use of GRATs — potentially depressed asset values and historically low interest rates — could change if the economy continues to show signs of improvement.

The Act also does not include other Obama Administration budget proposals including limiting discounts applied to transferred property or requiring consistency in the treatment

of asset basis for estate and income tax purposes. As a consequence of the significantly higher \$5 million exclusion amount, it would not be surprising to see valuation constraints become a more frequent topic in future proposed legislation. Alternatively, legislation proposed within the last two years would have acted, if enacted, to exclude so-called passive assets (generally investment assets) from the going concern value of a closely-held enterprise and would require that the donee's interest in these assets be separately valued.

Planning tip # 1: Prior to the Act, how best to utilize the \$1 million gift tax exclusion amount was the basis for a substantial part of most taxpayers' gift planning. Often the \$1 million exclusion amount was used in leveraged transactions such as a gift to a grantor trust followed by a purchase of assets from the grantor at some multiple of the gift made to the trust. Thereafter, GRATs were frequently used to transfer the appreciation on property away from the estate of the grantor because gifts to GRATs, appropriately executed, result in very small taxable transfers. While it is true that the \$5 million exclusion amount might be similarly used in further leveraged transactions, for a great many taxpayers the \$5 million exclusion (\$10 million per couple) is large enough that simple outright gifts, whether direct or in trust, may (for gifts made in 2011 and 2012) be the most efficient mechanism to transmit wealth.

Planning tip # 2: Assuming an outright gift of property either directly or in trust, the most effective use of the \$5 million exclusion is the transfer of less liquid, value-stressed property with the potential for significant future appreciation. Interests in closely-held businesses, fractional interests in real estate, or interests in entities owning significant real estate holdings, interests in private equity funds or other investment entities, perhaps even family owned investment entities, may prove the most successful candidates. As noted above, however, the Obama Administration has submitted tax proposals and other bills have been introduced in Congress that would restrict the ability to arrive at valuations that are less than an interest's proportionate share of enterprise value (for going concerns) and net asset value (for holding companies). Where such interests exist, prudence would dictate that consideration of their transfer not be unduly delayed.

Planning tip # 3: While GRATs are likely to become relatively less important to estate planning in 2011 and

2012 than they have been in the past, their appeal will remain high when:

- Prevailing interest rates remain low (note that the prevailing rate required to be used in GRAT gift tax calculations was at an all time low in December 2010 at 1.8%, that rate is now 2.8% in February 2011).
- Where the assets that are likely gift candidates are value-stressed.
- While short-term GRATs are still possible.

As indicated above, legislation requiring a minimum 10-year term for GRATs is a tax priority for the Obama Administration and several attempts were made in 2010 in both houses of Congress to introduce that limitation. Given the current political appetite for deficit reduction and balanced budgets, the prospects for such legislation in the future remain high. If shorter term GRATs appeal to your specific situation, prudence would direct that planning and implementation not be delayed.

Planning tip # 4: An annual gifting program can shift significant wealth down generational lines. This is especially true if the asset being transferred appreciates and/or generates income that will be excluded from the donor's estate. If you are interested in a gifting program, consider a trust as the recipient for these gifts. Certain types of trusts can be very tax-efficient vehicles for transferring wealth.

To demonstrate the power of annual gifting, assume a couple has three children. In 2011, this couple can transfer up to \$26,000 per child, or \$78,000 to all three children. If each child has a spouse, the maximum amount that can be given to the children and their spouses is \$156,000 without incurring a taxable gift. If the couple has grandchildren, the ability to further reduce their taxable estates through annual gifts expands.

Planning tip # 5: If your child or grandchild has earned income, consider making a cash gift. Your child or grandchild may use that gift to contribute \$5,000 or the amount of the donee's earned income, whichever is less, to a traditional IRA or Roth IRA. Funds contributed to a Roth IRA will grow tax deferred, and qualified distributions will be tax free for federal income tax purposes. Funds contributed to a traditional IRA may be deductible for income tax purposes by your child.

Planning tip # 6: Certain payments made directly to providers of medical and educational services are not treated as taxable gifts to the recipients of these services. For example, a grandmother who wishes to help pay for a granddaughter's education can write tuition checks directly to the school without making a taxable gift. If she writes the check to the granddaughter, however, she will have made a taxable gift to the extent the amount gifted exceeds the \$13,000 annual exclusion. Tuition is not limited to college tuition; any school tuition qualifies for this exclusion. Medical does not just mean doctors and hospitals; any medical expense, including insurance premiums, can be paid under this exclusion.

Planning tip # 7: Fund a Section 529 educational plan for children and grandchildren. Using a special election, you can fund up to five years of annual exclusions into these plans. In 2011, you can contribute \$65,000 to one grandchild's Section 529 plan without incurring a taxable gift or a GST tax (discussed in more detail later). If you make other gifts to that grandchild during 2011-2015, however, those gifts would use some of your lifetime applicable gift tax exclusion amount as well as some of your lifetime GST tax exemption, so think ahead. By funding these plans in advance, the growth in the fund occurs in an income-tax-exempt environment.

GST tax

The GST tax is imposed on transfers during life and at death that are made to a "skip person" — a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there were no GST tax, a gift to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a grandchild would be subject to transfer tax twice. Essentially, the GST tax is intended to tax the gift to the grandchild twice at the time it is made, to compensate for the otherwise skipped level of tax. The GST tax, when applicable, is a tax that is imposed in addition to the gift or estate tax; thus, a single transfer may be subject to double taxation.

For GST tax purposes, when a gift or bequest is made within a family, the focus is on the relationship of the transferor and the transferee and not their age difference. For example, you may have siblings who are significantly younger than you and who, therefore, have children who are significantly younger than you or your children. A transfer to a nephew who is 40

years your junior is not subject to GST tax because your nephew is only one generation younger than you. Conversely, a transfer to a grand-nephew who is only 30 years your junior is subject to GST tax because your grand-nephew is two generations younger than you. Married individuals are considered to be in the same generation, regardless of the spouses' age difference.

When the transferee is not related to the transferor, the age difference becomes important. If you transfer assets to a friend who is less than 12 years younger than you, that friend is considered to be in your generation and is not a skip person. If your friend is more than 12 years, but less than 37-1/2 years younger than you, that friend is considered one generation younger than you, and is, therefore, not a skip person. If your friend is more than 37-1/2 years younger than you, your friend is considered two generations younger than you, and is, therefore, a skip person.

There is also an annual exclusion amount available for transfers subject to GST tax. The GST tax annual exclusion amount, like the gift tax annual exclusion amount, is \$13,000 for transfers made in 2011. Unlike the gift tax annual exclusion, however, the GST tax annual exclusion is very limited for gifts to trusts.

The GST tax exemption amount permits the transfer of a certain amount of assets free of current and subsequent GST tax. The GST tax rate is equal to the maximum federal estate tax rate for the year that the skip person receives or becomes indefeasibly vested in assets. Prior to the Act, the statute kept the mechanics of the GST tax system in place but held that no GST taxable transaction could occur in 2010. Prior to the Act, GST tax was to reassert itself in 2011. How, mechanically, any GST transactions occurring in 2010 were to be reflected in subsequent years was a matter of some concern and no guidance was available. The Act retroactively reinstates the GST tax effective for decedents dying and transfers made after December 31, 2009. By fully reinstating GST tax retroactively, the questions regarding the continuity of the GST system through 2010 have been eliminated. The GST tax exemption in 2011 and 2012 will be \$5 million, coinciding with the reunified estate and gift exclusion. The GST tax rate remains equal to the highest estate tax rate in effect for such year — 35% for 2011 and 2012.

The Act clarifies that in 2010, GST tax still applied, but the tax rate for 2010 transfers was 0%. The GST tax exemption,

unlike the 2010 gift tax exclusion, also rises to \$5 million. But, unlike the 2011-12 estate tax regime, a decedent's unused GST tax exemption is not portable and cannot be carried over to a surviving spouse. Should a 2010 estate elect out of the estate tax rules and into the modified carryover basis rules, that election does not affect a decedent's identity as a transferor for GST tax purposes nor does it reduce the decedent's \$5 million 2010 GST tax exemption.

For generation-skipping transfers made from January 1, 2010, through December 17, 2010, the due date for filing a return, including any elections required to be made on the return, will be September 17, 2011. Generation-skipping transfers (including taxable distributions and taxable terminations of interests in existing trusts) made between December 17, 2010 and January 1, 2011, are subject to normal compliance deadlines, which, in some cases, will be April 15, 2011.

Planning tip # 1: Grandparents wanting to make a substantial gift to a grandchild should consider establishing a minor's trust, also known as a Section 2503(c) trust. Gifts to a minor's trust qualify for both the gift and GST tax annual exclusions. For example, a married couple can transfer up to \$26,000 per year to each grandchild without incurring gift or GST tax. The property and associated income must be available for distribution before the grandchild attains age 21, and, generally, any remaining balance must be distributed to the grandchild at age 21.

Another type of trust sometimes used for gifts to minors, known as a Section 2503(b) trust, requires all income from the trust to be distributed annually, but does not require the property to be distributed to the grandchild at age 21. Note, however, that a \$13,000 gift to a Section 2503(b) trust for the benefit of a grandchild may not be fully excludable by the gift tax and GST tax annual exclusions. These limitations may be overcome if the trust contains special additional provisions (under Section 2642(c)) to qualify the gift for the gift tax and GST tax annual exclusions.

Planning tip # 2: A dynasty trust, described further below, is a trust designed to skip multiple generations, thus more fully utilizing the benefit of the GST tax exemption. A typical GST tax-exempt dynasty trust is used to transfer income and/or principal to multiple generations, including children, while paying estate or gift tax only upon the initial

transfer to the trust, thus avoiding both estate tax and GST tax at each subsequent generation. Dynasty trusts, like many irrevocable trusts, may also offer significant asset protection from creditors. Although gift tax annual exclusions may be available when funding a dynasty trust, transfers to such trusts do not qualify for the GST tax annual exclusion, so the donor's unused GST tax exemption will be allocated dollar for dollar when these trusts are funded.

Planning tip # 3: Dynasty trusts are permitted in all states, but laws in many states limit the duration of a trust to a term from 80 to 110 years after they are created. Most states allow the trust to continue until 21 years after the death of the last surviving descendant of the trust creator who was living at the time of the trust's creation. Other states have recently amended their trust statutes to permit trusts to exist into perpetuity. An individual may create a trust in a state other than his or her state of residence. For example, assume in 2011 a couple funds an irrevocable dynasty trust with \$5 million each. Neither spouse has previously made taxable gifts. No gift or GST tax is due upon funding the trust because each spouse utilizes his or her available gift tax exclusion amount and his or her GST tax exemption at the time the trust is funded. Assume the trust has an after-tax growth rate of 4%, which is added to trust principal each year. After 110 years, the trust is worth approximately \$747.5 million. Under present law, there are no transfer taxes due on distributions during the duration of the trust or distributions of trust assets when the trust terminates.

Planning tip # 4: Given the greater GST tax exemption currently available, if you have existing GST trusts that have an inclusion ratio of between zero and one (that is a trust where a distribution to a skip-person would be partially subject to GST tax), consideration should be given to allocating the increased exemption to those trusts as quickly as possible. When a trust has an inclusion ratio of between zero and one, the amount of GST tax exemption required to obtain an inclusion ratio of zero (thus making the trust thereafter exempt from GST tax) is a function of the value of the trust's assets at the time the additional GST tax exemption allocation is made. If the trust's assets are likely to appreciate relative to their current value, it is possible that less exemption will be required if the allocation is made now as opposed to some later date.

Miscellaneous provisions

The Act also extends the following GST modifications enacted as part of EGTRRA:

- The GST tax exemption will be allocated automatically to most transfers to GST trusts made during life. An individual may generally elect out of the automatic allocation rules where appropriate.
- Under certain conditions, the GST tax exemption can be allocated retroactively.
- Those inadvertently failing to make timely elections to allocate the GST tax exemption in those situations where an automatic allocation could not occur will have the opportunity to seek relief from Treasury.
- A “qualified severance” of a trust into two or more trusts, under the governing instrument or local law, will be respected for GST purposes.
- The value of property to be used for determining the inclusion ratio is the property’s finally determined gift tax value or estate tax value.
- Substantial compliance with the statutory and regulatory requirements for allocating the GST tax exemption — again, in those cases where the automatic allocation rules could not apply — will suffice to establish that the GST tax exemption is allocated to a particular transfer or trust.

Beyond 2012

Taxpayers now have two more years of certainty with respect to the estate, gift, and GST taxes. Despite the significantly higher gift and estate tax exclusion amount of \$5 million, estate taxes will remain a big concern for many because after 2012, under current law, the highest marginal estate tax rate may yet be as high as 60%. With the sunset of the estate tax provisions of the Act and EGTRRA, the estate tax in 2013 will be calculated using an applicable exclusion amount of \$1 million, a top rate of 55%, and a 5% surtax on net taxable estates in excess of \$10 million until the lower tax brackets and applicable credit amount are recaptured. States with “piggyback” estate tax laws will suddenly have estate taxes to collect again. States that “decoupled” their estate tax from the federal estate tax will have to address modifications to their laws and many taxpayers could end up with new state laws to plan for. Until those adjustments are made, estates will face a patchwork of laws that may produce unexpectedly high effective estate tax rates.

Should Congress not act before 2013, other significant changes will take place in the federal estate, gift, and GST tax areas as modifications made in these areas by EGTRRA and the Act expire. These include:

- The family-owned business deduction will apply to certain estates.
- The expanded availability of the qualified conservation easement will no longer apply.
- The more liberal estate tax installment payment rules described above will expire.
- The state death tax credit, for estate tax purposes, will be reinstated.
- The favorable GST tax rules noted above will expire as they are replaced with the less advantageous rules in effect before (including a GST tax exemption of \$1 million indexed for inflation (i.e., approximately \$1.34 million for 2011), and a 55% tax rate).

Taxpayers and estate planners alike should remain vigilant as the end of 2012 approaches because the possibility exists that two years from now the future of the federal estate, gift, and GST taxes may once again become unclear. Although Congress could make changes beforehand, looking ahead to 2013, there can only be speculation regarding the future of these taxes as the new Congress advances its agenda. Keeping informed of tax legislative developments will give you the best opportunity to plan ahead and react quickly as more changes transpire.

Seeking the advice and guidance of an experienced tax professional in implementing a wealth transfer plan that reduces your estate, gift, and GST tax liabilities has always been a prudent course of action. Now, in these times of unprecedented wealth transfer opportunity brought about by the reunification of the GST tax exemption and estate and gift tax exclusion at \$5 million, and the limitation of the top tax rates at 35%, getting qualified advice to capitalize on what may be a two-year window is imperative.

Individual income tax relief

The Act amends the general sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) to provide that the tax changes made by those acts will now stay in place through 2012. As a result, the Act extends several principal components of the individual tax system through 2012:

- The lower rates on earned income enacted in EGTRRA and the lower rates on long-term capital gain and qualified dividend income enacted in JGTRRA.
- The changes in the standard deduction and rate brackets that provide marriage penalty relief.

The Act increases the exemption amount under the AMT and permits nonrefundable personal credits to be claimed against the AMT for 2010 and 2011. The Act also extends 50% bonus depreciation and small-business expensing through 2012, and a 100% expensing allowance for property placed in service after September 8, 2010, through 2011. In addition, the Act extends a host of other temporary provisions affecting individuals, and provides a payroll tax holiday for employees in 2011.

Income tax rates

For the next two years, the six individual income tax brackets ranging from 10 to 35% will remain in place. The top income tax rates on income from qualified dividends and long-term capital gains will hold at 15%. For those with qualified dividends and long-term capital gains taxed in the lowest two tax brackets, the tax rate will remain at 0%.

Under the Act, individual ordinary income tax rates will return to their pre-EGTRRA levels — five brackets with rates of 15, 28, 31, 36, and 39.6% — in 2013. Similarly, tax rates on investment income will return to their pre-JGTRRA rates in 2013: long-term capital-gain rates will increase to 10% and 20% and dividends will be taxed as ordinary income with a top rate of 39.6%. The top individual income tax rate in 2013 does not include the rate increases enacted by the Patient Protection and Affordable Care Act of 2010, which are applicable to high-income taxpayers. These rate increases include an additional 0.9% Medicare Hospital Insurance tax on self-employed individuals and employees and an unearned income Medicare contribution of 3.8% on certain investment income. Both of these law changes are effective in taxable years beginning after December 31, 2012.

The Act also extends for two years the repeal of two provisions that effectively increase marginal tax rates for higher-income individuals: the personal exemption phaseout and the itemized deduction limitation. Prior to EGTRRA, taxpayers with income above a certain threshold were required to reduce their itemized deductions and personal exemptions. EGTRRA phased out the limitations on personal exemptions and itemized deductions so that they were completely eliminated beginning in 2010.

Marriage penalty relief

Before the enactment of EGTRRA, some two-earner married couples experienced a “marriage penalty” — in other words, their joint tax liability was greater than the sum of their separate individual tax liabilities (computed as if they were single). To substantially reduce the number of couples subject to such a penalty, EGTRRA expanded the standard deduction for joint filers to twice the deduction for single filers and expanded the 15% bracket for joint filers until it was double the size of the corresponding rate bracket for single filers. The Act extends EGTRRA’s marriage penalty relief provisions through 2012.

Alternative minimum tax relief

As part of the Act, Congress extended AMT relief for 2010 and 2011. The adoption of another so-called AMT “patch” will prevent roughly 25 million taxpayers from being swept into the AMT system. The last AMT patch expired at the end of 2009, allowing the AMT exemptions for 2010 to drop to \$33,750 for single taxpayers and \$45,000 for joint filers.

The Act increases exemption amounts under the individual AMT to \$47,450 for unmarried filers and \$72,450 for married-joint filers for 2010, and to \$48,450 for unmarried filers and \$74,450 for married-joint filers in 2011. The change provides greater protection from the AMT — particularly to taxpayers who claim large itemized deductions for state and local taxes and those who have a large number of dependents. The fact that this relief applies only through 2011 means that Congress will be under pressure to approve another patch before the end of the year.

Bonus depreciation and expensing

The Act extends for two years current-law bonus depreciation, which allows 50% bonus depreciation for qualified property. Bonus depreciation will be available for qualified property placed in service before January 1, 2013 (or before January 1, 2014, in the case of certain long-term production property). Under a special rule, if qualified property is acquired and placed in service after September 8, 2010, but before January 1, 2012, the bonus depreciation amount is increased from 50% to 100%. Generally, qualified property includes property with a MACRS recovery period of 20 years or less, certain computer software, or qualified leasehold improvement property. In addition, the Act provides for a temporary election to claim a refundable credit in lieu of bonus depreciation for property placed in service in 2011 and 2012.

The Act also provides an additional year of increased Section 179 small-business expensing limitation. For tax years beginning in 2010 and 2011, the Section 179 small-business expensing limitation was increased to \$500,000. The limitation is reduced for those years if the cost of the Section 179 property exceeds \$2 million. After 2011, the limitation was set to return to \$25,000 and the reduction was set to return to \$200,000. The Act provides that for tax years beginning in 2012, the limitation is raised to \$125,000, and the reduction begins at \$500,000. Those amounts will return to \$25,000 and \$200,000, respectively, after 2012.

Miscellaneous individual provisions

The Act includes a new temporary reduction of the Social Security payroll tax for wage earners and self-employed individuals. As a result, the 6.2% and 12.4% rates applicable under current law to wage earners and self-employed individuals, respectively, are reduced to 4.2% and 10.4% for 2011. This relief applies to all individuals subject to Social Security tax without regard to any limit on the amount of wages or other income they receive. Employees will receive the benefit of the payroll tax holiday through reduced withholdings. Self-employed individuals can reflect the reduced rates in their estimated tax payments. This partial payroll tax holiday effectively replaces the benefit of the \$400 per individual (\$800 per couple) that was that was available for 2009 and 2010 under the Making Work Pay tax credit.

The Act extends through 2011 the provision for tax-free distributions from individual retirement plans for charitable purposes by individuals age 70-1/2 and older (up to \$100,000 per taxpayer per taxable year). As in prior years, such charitable distributions count towards the IRA owner's minimum required distribution. Individuals may make an election to have a qualified charitable distribution made in January 2011 treated as having been made on December 31, 2010 (and thus would be treated as having been made in the 2010 taxable year). The Act also extends through 2012 prior increases or expansions of other tax benefits, including the child tax credit, the dependent care credit, the itemized deduction for state and local general sales taxes, and the American Opportunity Credit for higher education.

Planning considerations for individuals

With these extensions, individuals will find that the rules governing their 2010 and 2011 tax returns will differ little from those of prior years. Given that rates will be consistent between 2010, 2011, and 2012, planning should focus on an individual's specific fact pattern and objectives in a manner that would allow them to manage tax on income when realized and enhance the benefit of deductions.

Planning items that should be considered include:

- Preparation of multiyear tax projections as a means of managing tax on income realized and determining which year can enhance the benefit of deductions.
- As part of multiyear tax projections, consider undertaking AMT planning with an emphasis upon whether acceleration/deferral of income and/or acceleration/deferral of deductions will assist an individual in minimizing his or her AMT exposure. (See the Planning tips under "Alternative minimum tax" in the Income tax section of *The 2011 essential tax and wealth planning guide*).
- Consider whether you will be in a net capital-gain position for 2011 and whether you have losses that can be accelerated to offset those gains. When planning for capital gains and/or losses it is important to address wash sales, worthless securities, and nonbusiness bad debts. (See the Planning tips under "Capital gains and capital losses" in the Income tax section of *The 2011 essential tax and wealth planning guide*).

- Consider conversion of a traditional IRA into a Roth IRA. (See the Planning tip under “Roth IRA conversions” in the Income tax section of *The 2011 essential tax and wealth planning guide*). Also, if you converted your IRA to a Roth IRA during 2010, review whether to elect to treat income as earned 100% in 2010 or 50% in 2011 and 50% in 2012. It may seem counter-intuitive to accelerate the income into 2010 given that tax rates are consistent for the three years. However, an individual’s specific facts and circumstances — especially his or her exposure to AMT — needs to be analyzed to determine if their fact pattern provides a better tax result to accelerate the income into 2010 or to defer the income into 2011 and 2012.
- Review potential losses, basis considerations, and at-risk limitations relating to an interest in a passthrough entity. (See the Planning tips under “Passive gains and losses” in the Income tax section of *The 2011 essential tax and wealth planning guide*).
- Consider making a distribution directly from an IRA to a charity in lieu of receiving your minimum required distribution. This can be accomplished in January 2011 and be treated as having been made on December 31, 2010, and can also be accomplished during 2011 and count toward the IRA owner’s minimum required distribution for 2011.
- Those who have substantial investment income can now make decisions about rebalancing investment portfolios with a sense of confidence about the tax impact of earning dividend income or capital appreciation. (See the Planning tips under “Tax rates on dividends” in the Income tax section of *The 2011 essential tax and wealth planning guide*).

Planning considerations for private enterprises

- Consider the impact of the temporary 2% Social Security tax holiday to partners (members) who earn self-employment income from a partnership (LLC) in calendar year 2011.
- The Act temporarily extends the special rule applying to the reduction in an S corporation shareholder’s basis when the S corporation makes a charitable contribution of appreciated property. Affected S corporation shareholders should carefully analyze the amount of charitable deduction they may claim and consider the impact of any basis limitations.
- Enterprises interested in preserving and increasing cash flow can reduce current-year tax liability through the use of bonus depreciation. Enterprises should consider purchasing and placing in service qualified property prior to December 31, 2011, in order to be eligible for 100% bonus depreciation, or prior to December 31, 2012, for 50% bonus depreciation. Manufacturing enterprises should consider the effects of bonus depreciation reducing the Domestic Production Activities Deduction and increasing inventoriable costs under Uniform Capitalization rules.
- Corporate entities may elect to monetize AMT credits generated prior to 2006 in lieu of bonus depreciation. The refundable AMT credit is limited to the lesser of 6% of pre-2006 AMT credits or \$30 million. If the election to monetize pre-2006 AMT credits is made, straight-line depreciation must be used for property otherwise eligible for bonus and MACRS depreciation.
- Enterprises should consider forgoing bonus depreciation if at risk for expiring net operating losses, expiring research and development credits, or if the enterprise is in a current year taxable loss position with no carryback potential. An enterprise wishing to forgo bonus depreciation must explicitly elect out of bonus depreciation on the timely filed tax return. If bonus depreciation is not utilized, the omission of an election statement may result in loss of future depreciation.
- Small businesses anticipating placing in service property of \$200,000 to \$500,000 within a given year should consider purchasing and placing in service such property prior to January 1, 2013, in order to benefit from the increased section 179 small-business expensing limitation.

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