



Family Investment C Corporation

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Member HSBC Group

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* This was presented using a C Corp as the structure nerve center, but is also applicable to the LLC nerve center model



Objectives

- Provide long-term asset management
- Maximize income tax deductions for fees paid in regards to investment management & advisory fees, income tax preparation fees, and other deductible expenses
- Provide vehicle for estate planning

First capital gains tax rate cut since 1981.

Two-tier approach:

- 28% top rate on net long-term capital gains reduced to 20% (15% rate reduced to 10%) -- **effective for gains after 5/6/97**.
 - **from 5/7/97 - 7/28/97**, applies to assets held more than 12 months.
 - **effective 7/29/97**, applies to assets held more than 18 months.
(Note: Assets held more than 12 months but not more than 18 months still qualify for 28% top rate.)
- 20% top rate reduced to 18% (10% rate reduced to 8%) for assets held more than 5 years -- **effective in 2001**.
 - 18% rate applies to **assets acquired after 2000**.
 - mark-to-market **election for assets held on 1/1/01** so as to restart the holding period.
 - gains recognized, but not losses.
 - for 10% rate, no requirement assets be acquired after 2000.

For tax years including **5/7/97**, lower rates apply to net capital gain taken into account after **5/6/97**.

-- Impact: **installment sale payments received after 5/6/97** get lower rate.

Other issues:

- for **pass-through entities** (partnership, S corporation or RIC), character of gain (pre-May or not) based on when entity received capital gains
- same reduced rates apply for **alternative minimum tax (AMT)** purposes
- 20% rate **applies to most capital assets, except**:
 - **collectibles** (fine art, jewelry),
 - **certain real property gains**, and
 - **qualified small business stock** (see next slides).

Planning:

- modify portfolio holdings to emphasize growth taxable at capital gains rates rather than income that is taxed at top rates for ordinary income.
- execute stock sales before ex-dividend date to capture at capital gains rates, appreciation element due to corporate earnings.

seek stock options, especially incentive stock options, from employers to convert compensation income to capital gains.

- take early payments of deferred compensation and distributions from qualified retirement plans and invest after-tax funds to take advantage of low capital gains rate.

Comments:

Taxpayers with incentive stock options need to be careful to avoid an AMT trap. The bargain element is taxable under the AMT upon exercise of the option. While the stock could receive the 20% capital gains rate for regular tax purposes when sold, it may be difficult to use the full AMT credit generated in the year if the ISO was exercised. Result: Higher effective tax rate than 20%.

Family Investment (C Corporation)



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Creation of Family Investment – C Corporation

■ Current Hurdles

- The ability to deduct investment management & advisory fees, income tax preparation fees, and other deductible expenses on the Individual Income Tax return is problematic because of the following:
 - **Alternative Minimum Tax:** Investment management & advisory fees, income tax preparation fees and other deductible expenses are not deductible for the Alternative Minimum Tax computation
 - **2% Limitation under Other Miscellaneous Deductions:** Investment management & advisory fees, income tax preparation fees, and other deductible expenses are deductible only to the extent that they exceed 2% of adjusted gross income
 - **3% of Adjusted Gross Income Limitation:** Assuming the investment management & advisory fees, income tax preparation fees, and other deductible expenses clear the first two hurdles, they are additionally reduced by 3% of adjusted gross income with modifications along with all other itemized deductions

The interplay of these three factors frequently cause the investment management & advisory fees, income tax preparation fees, and other deductible expenses to be non-deductible.



Creation of Family Investment – C Corporation

■ Potential Solution

- Form an Investment Management Corporation (a C Corporation) which serves as a family office to handle investment management for the family (and possibly others).
- The newly formed C Corporation would contract with the third party service providers and pay the investment management & advisory fees, income tax preparation fees, and other deductible expenses.
- The newly formed C Corporation would serve as a general partner in a newly formed New Partnership where it contributes a small amount of capital (typically 0.2% - 1%) and gets a profits allocation which is disproportionate to its capital.
- The Family Investment-C Corporation would be able to net the investment income against its investment management & advisory fees, income tax preparation fees, and other deductible expenses.

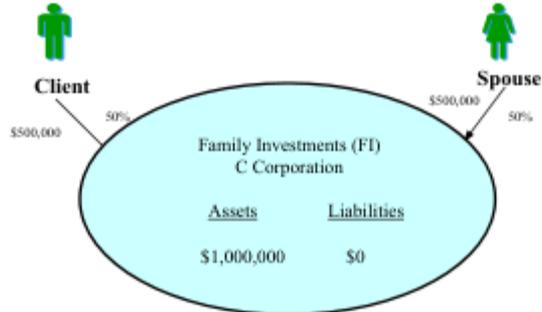


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Creation of Family Investment – C Corporation

Creation of Family C Corporation

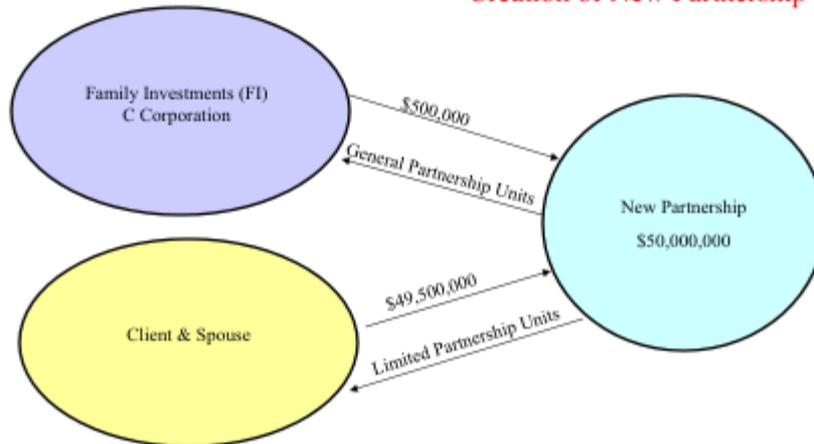


Client and Spouse will contribute a nominal amount to create a C Corporation, Family Investments. Family Investments will manage Client and Spouse's investments and pay professional fees in relation to the production of income. The contribution of assets will qualify as a tax free exchange under Section 351.

The contribution into Family Investments is dependent upon the anticipated expenses of the family office and the contributions that Family Investments will need to make into the Family Partnership or LLC's established.



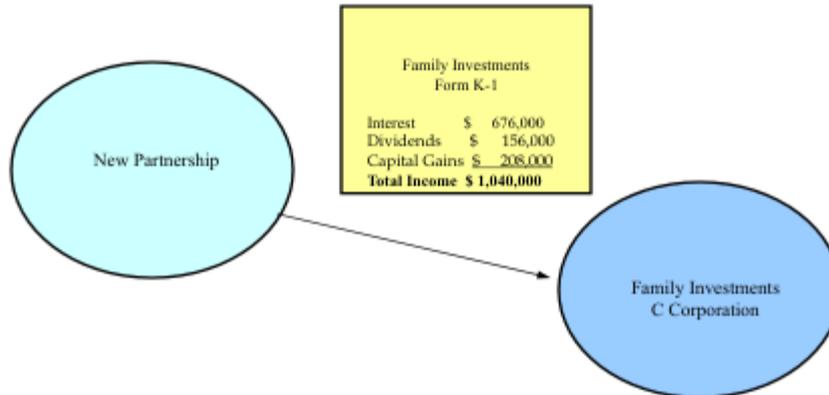
Creation of New Partnership



Family Investments will contribute cash between 0.2% to 1% into New Partnership and have General Partnership units in exchange. The individual will contribute their already diversified portfolio into New Partnership and take back limited partnership units. Note a LLC as well as multiple partnerships can be utilized within the structure.



Interaction Between New Partnership and Family Investments



In exchange for handling the investment management for the New Partnership, Family Investments will receive a management fee of 10 basis points along with a profit interest of 20% on the first \$5 million of income generated by the Partnership. The profits interest would then cascade in a waterfall scenario to lower percentages based on increased profits of the partnership. Family Investments will receive a K-1 for its profits interest as well as its management fee.



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Income Statement of Family Investments - C Corporation

Family Investments C Corporation	
K-1 Income	\$1,040,000
Expenses	<u>\$1,100,000</u>
Net Loss	(\$60,000)

In the optimal scenario, the profits override on the partnership interest enables the Family Investments to cover legitimate business expenses. It is anticipated that in the first year Family Investments will generate an NOL which will be carried forward to future years. The Family Investments will be reimbursed by Client and Spouse for any personal expenses.



New Partnership



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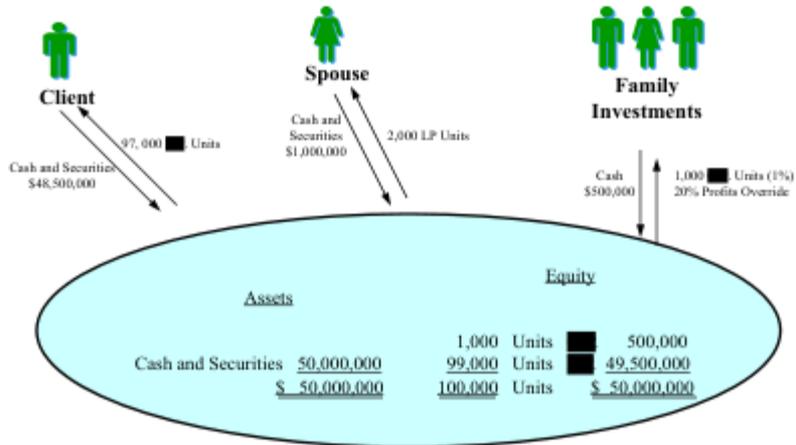
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New Partnership Key Terms

- Dissolution Date - December 31, 2103
- Only General Partners can Terminate the Partnership Early
- Limited Partners Have No Right to Withdraw
- Limited Partners Cannot Participate in Management
- Partnership Shall Continue Upon Death of a General Partner if There is One or More Surviving General Partners.
- Limited Partners May Transfer Their Interest Subject to a Right of First Refusal.



Formation of the New Partnership



Client, Spouse, and the Family Investments create a family limited partnership for which they receive the interests detailed above.



Income Statement of New Partnership

Family Limited Partnership Income	
Interest	\$ 3,250,000
Dividends	\$ 750,000
Capital Gains	<u>\$ 1,000,000</u>
Total Income	\$5,000,000

Benefits of Family Partnership

Non-Tax Benefits of Family Partnership

- Consolidates Family Investments
 - Reduce Management Fees Through Economies of Scale
 - Increases Diversification
 - Promotes Family Interaction
- Parents Retain Control During Life
- Centralized Management
- Children receive an Illiquid Asset
- Limited Asset Protection
 - Creditors
 - Divorce



Benefits of Family Partnership (continued)

Income Tax Benefits of Family Partnership

- Provides Investment Vehicle for Smith Family C Corporation to Generate a Profits Interest
- No Double Taxation of Income
- Future appreciation passes tax free

Additional Estate Tax Benefits of Family Partnership

- Future Appreciation Passes Tax-Free
- Discounts Pass Existing Value Tax-Free
- Leverage Available to Maximize Freeze
- No Ownership Restrictions- Compare S Corporation



Disadvantages of a Family Partnership

- **Potential Disadvantages**
- Carryover of Donor's Tax Basis
- Depreciation Risk, i.e. Partnership May Decline in Value
- Possible IRS Challenge:
 - Valuation
 - Estate Inclusion
- Administrative Cost

