Deferring and Avoiding the Tax on Net Investment Income

Finding Flexibility in the Fiduciary Toolbox

Sioux Falls Estate Planning Council
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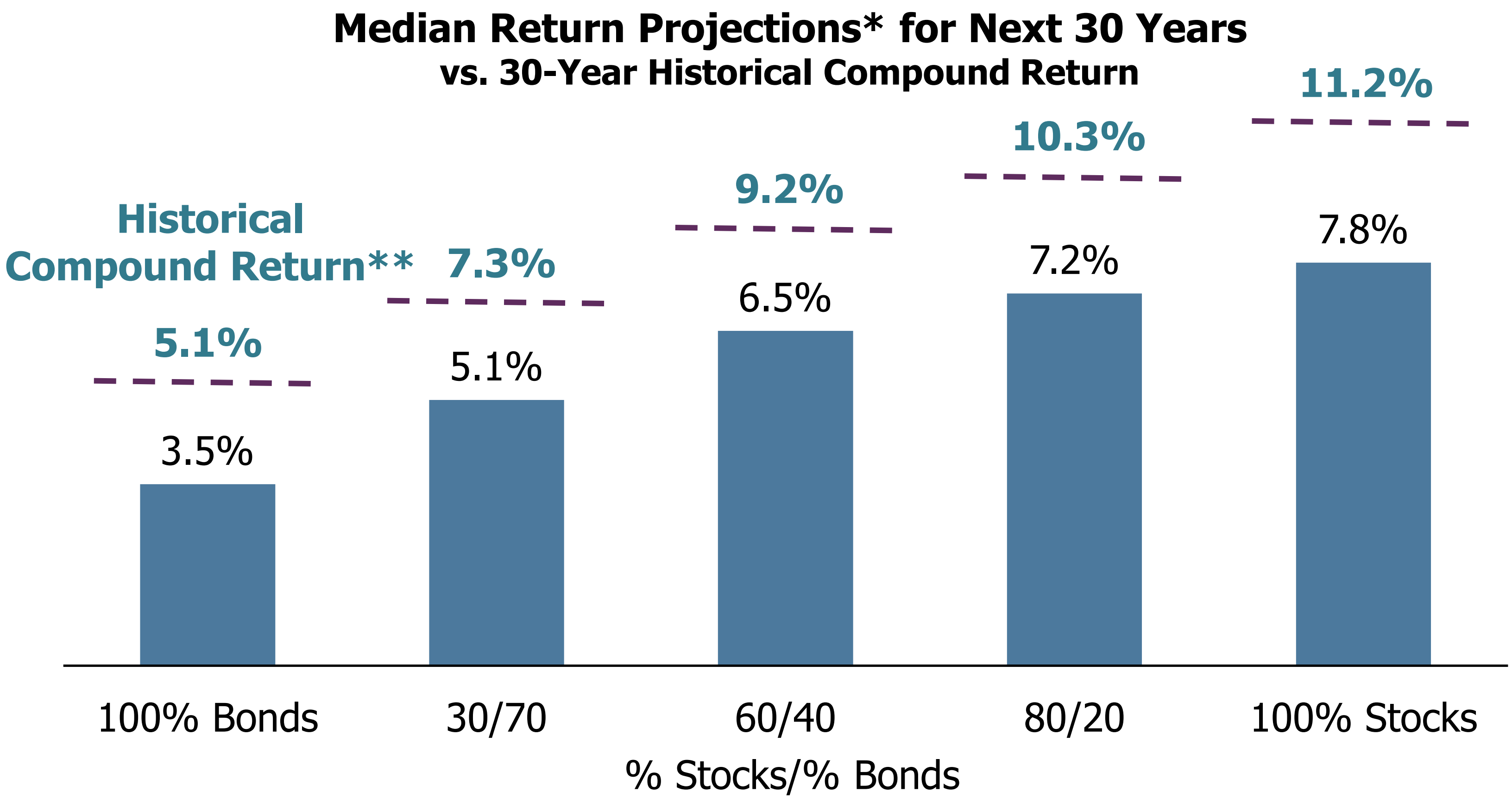
I. Current Conditions

Future Returns Are Likely to Be Lower



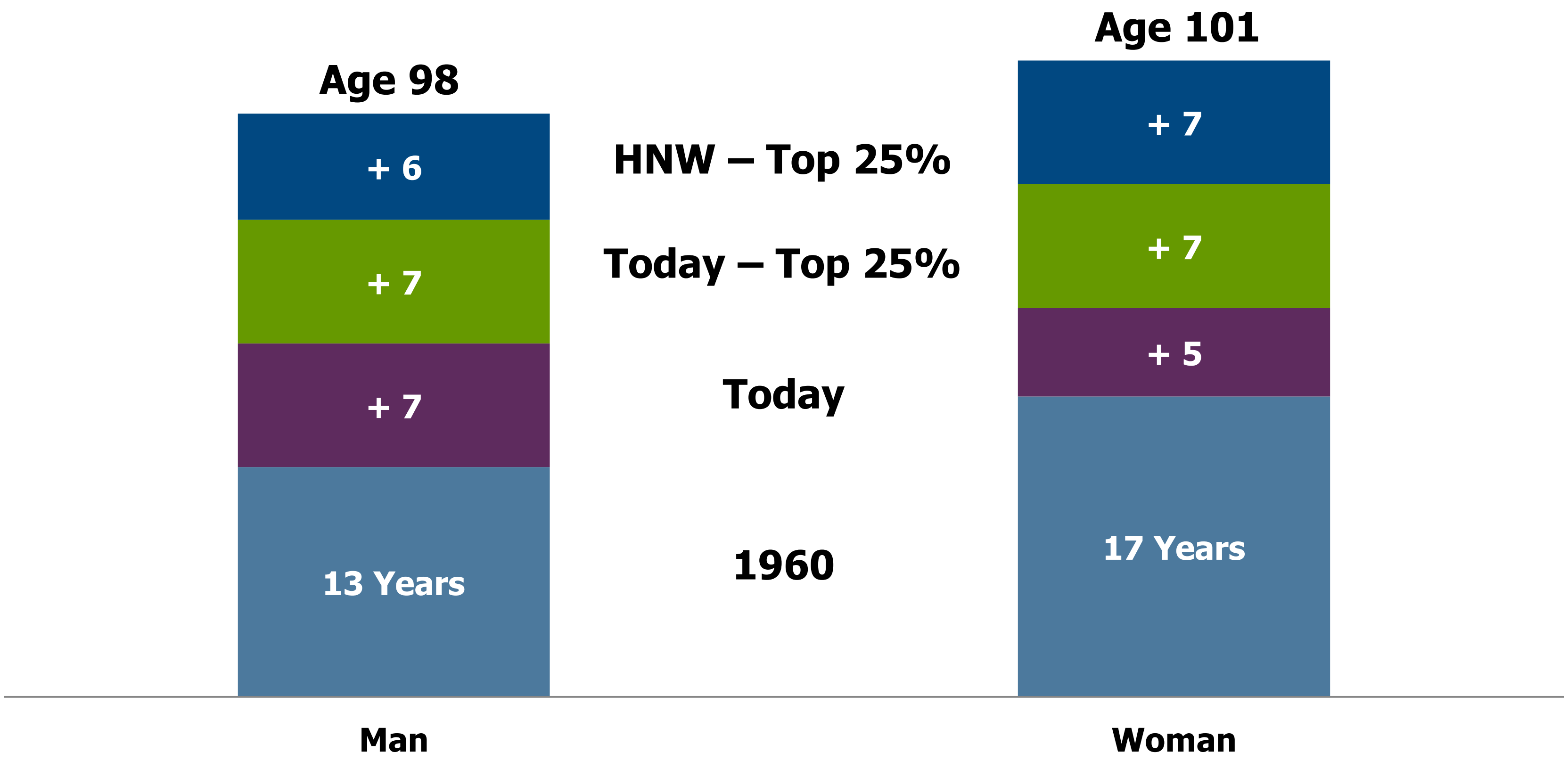
*Projected pretax 30-year compound annual growth rate. Stocks (or "global equities") are modeled as 21% US diversified, 21% US value, 21% US growth, 7% US small/mid-cap, 22.5% developed international and 7.5% emerging-market stocks, and bonds are modeled as intermediate-term diversified municipal bonds. Reflects Bernstein's estimates and the capital-markets conditions as of December 31, 2013. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of future results or a range of future results. See Notes on Wealth Forecasting System for further details.

**Historical compound return calculated from January 1, 1984, through December 31, 2013 with equities represented as follows: 70% S&P 500 and 30% MSCI EAFE from 1984 through 1987, and 70% S&P 500, 25% MSCI EAFE and 5% MSCI EM thereafter; bonds represented by the Lipper Short/Intermediate Municipal Bond Fund Average.

Source: Lipper, MSCI, Standard & Poor's and AllianceBernstein

People Are Living Longer

Average Life Expectancy for a 65-Year-Old*



*Sources: Social Security Administration, Society of Actuaries, and M Financial Group

Recent Legislation Increased Federal Tax Rates

Top Marginal Federal Income Tax Rates*

	Pre-2013	Today	% Change (Today/Pre-2013)
Qualified dividends	15%	23.8%	59%
Long-term capital gains	15	23.8	59
Taxable interest	35	43.4	24
Earned income (including OASDI and Medicare)**	40.65	48.15	18

*Based on Health Care and Education Reconciliation Act of 2010 and American Taxpayer Relief Act of 2012; assumes joint filer with both earned income and adjusted gross income above $250,000.

**In 2013, OASDI rate returned to pre-2011 level of 6.2%, and Medicare tax rate increased to 2.35% for wages in excess of $200,000 (single filer) or $250,000 (joint filer). "Earned income" blended rates do not account for phase-out of OASDI for wages in excess of threshold amount ($117,000 in 2014, indexed for inflation thereafter). Tabulated figures exclude state and local taxes.

Sources: IRS and AllianceBernstein

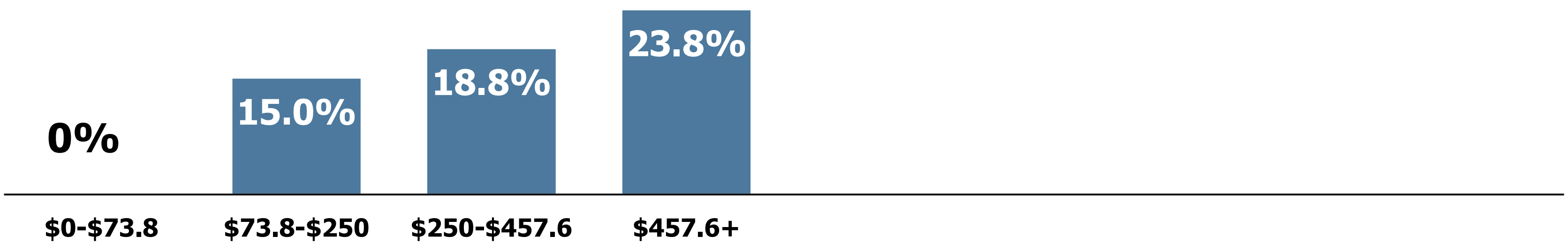
Progressivity of Federal Tax Brackets Has Increased

Marginal Federal Tax Rate on Long-Term Capital Gains and Qualified Dividends*

Joint Filers, Income Brackets ($ Thou.)

Long-Term Capital Gain	Tax
$500k—Top Marginal	$119,000
$500k—Full Bracket Run	$75,550

Δ = $43,450



*Based on Health Care and Education Reconciliation Act of 2010 and the American Taxpayer Relief Act of 2012. Long-term capital gains rates in 2014: 0% on capital-gains portion of taxable income up to $73,800, 15% on income over $73,800 to $457,600, and 20% on income above $457,600. Medicare surtax of 3.8% applies to net investment income that exceeds a modified adjusted-gross-income of $250,000. All income thresholds are based on joint filers. Bernstein is not a legal, tax or estate advisor. Investors should consult these professionals as appropriate before making any decisions.
Source: IRS and AllianceBernstein

3.8% Medicare Surtax on Net Investment Income (NII)

- Not just a rate increase . . . a completely separate tax on the passive income of certain high-income individuals, trusts, and estates
  - NII includes
    - Interest, dividends, rents, and royalties
    - Capital gain income
    - Nonqualified annuities
    - Trade or business in which the taxpayer did not materially participate
  - NII excludes
    - Active income derived from a trade or business
    - Tax-exempt bond interest
    - Gain on sale of principal residence
    - Qualified retirement plan or IRA distributions
    - Nonqualified deferred compensation
    - Exercise of incentive stock options (ISO)
    - Social Security income
    - Alimony received

Source: IRS and AllianceBernstein

Deductions Against NII

- Deductible by individuals and trusts to the extent attributable to NII
  - State income taxes
  - Local and foreign income taxes
  - Ordinary and necessary expenses incurred in obtaining a tax refund
  - Ordinary and necessary expenses incurred by fiduciary in the administration of a trust or estate
  - Other specified investment and miscellaneous expenses

- Deductible by trusts and estates to the extent attributable to NII
  - Income distribution deduction
  - Section 642(c) deduction for charitable contributions and set asides

For individuals, trusts, and estates, the surtax is computed separately on Form 8960

Source: IRS and AllianceBernstein

Not Deductible Against NII

- The following categories of normally deductible expenses (among many others) are not deductible against NII
  - Alimony paid
  - Contributions to qualified plans and IRAs
  - Standard deduction and personal exemption
  - Charitable contributions
  - Medical expenses
  - Mortgage interest
  - Real estate taxes
  - Sales taxes

Source: IRS and AllianceBernstein

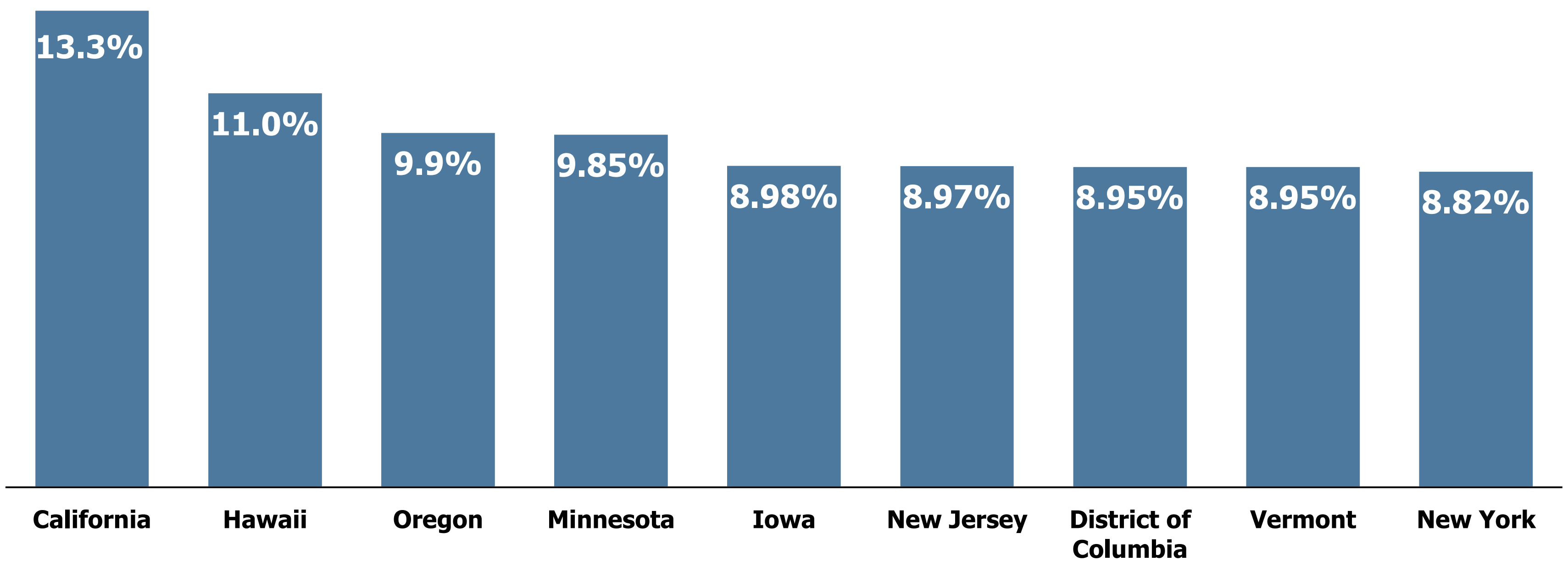
Who Are "High-Income" Taxpayers?

- Tax on NII is 3.8% of the lesser of
  - Net investment income; or
  - Excess, if any, of
    - Modified adjusted gross income, over
    - "Threshold amount," which is
      - $250,000 for married couples filing jointly
      - $200,000 for single filers
      - $125,000 for married taxpayer filing separately

- For a taxable trust or estate, tax on NII is 3.8% of the lesser of
  - Undistributed net investment income*; or
  - Excess, if any, of
    - Adjusted gross income, over
    - Threshold amount of $12,150 (inflation-indexed)

*Equals net investment income, reduced by (i) distributions of net investment income to beneficiaries; and (ii) deductions under Code Section 642(c). See Form 8960, line 18c, www.irs.gov./pub/irs-pdf/f8960; Instructions for Form 8960, line 18c, www.irs.gov/pub/irs-pdf/i8960.
Source: IRS and AllianceBernstein

Highest 2014 State Income Tax Rates*

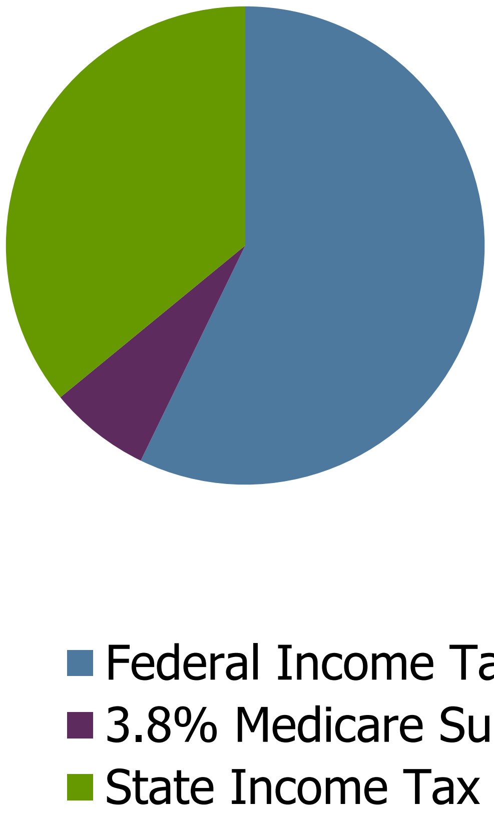


*As of January 1, 2014. Top rate on "last dollar" of income. Local income taxes not included.
Source: taxfoundation.org

In the "Grand Scheme," How Important Is the 3.8% Surtax?

Attribution of Overall Tax Liability to Its Sources
California Taxpayer, Federal and State Taxes on Long-Term Capital Gains and Qualified Dividends*
Joint Filers

Total Capital Gains & Qualified Dividend Income	$500,000	% of Total	% of Tax Paid
Federal Income Tax	($66,050)	13.2%	57.2%
3.8% Medicare Surtax	($7,922)	1.6%	6.9%
California State Income Tax	($41,518)	8.3%	35.9%
Net Remaining After Tax	$384,510	76.9%	

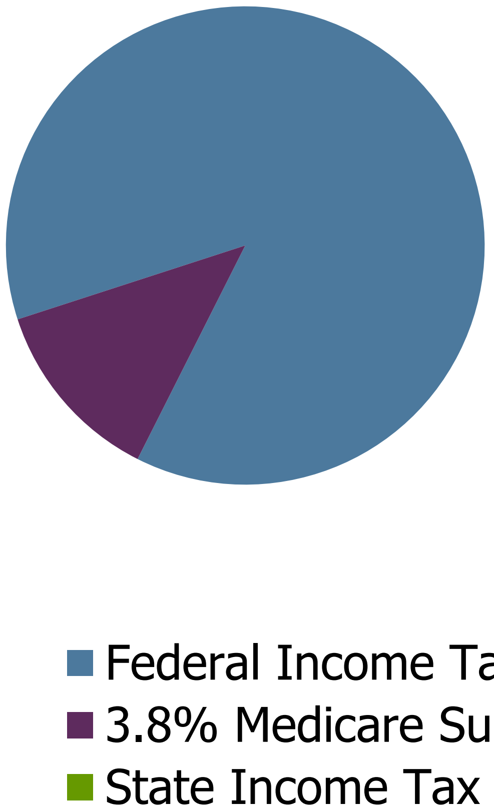


*Sources: IRS, taxfoundation.org, and AllianceBernstein

In the "Grand Scheme," How Important Is the 3.8% Surtax?

Attribution of Overall Tax Liability to Its Sources
South Dakota Taxpayer, Federal and State Taxes on Long-Term Capital Gains and Qualified Dividends*
Joint Filers

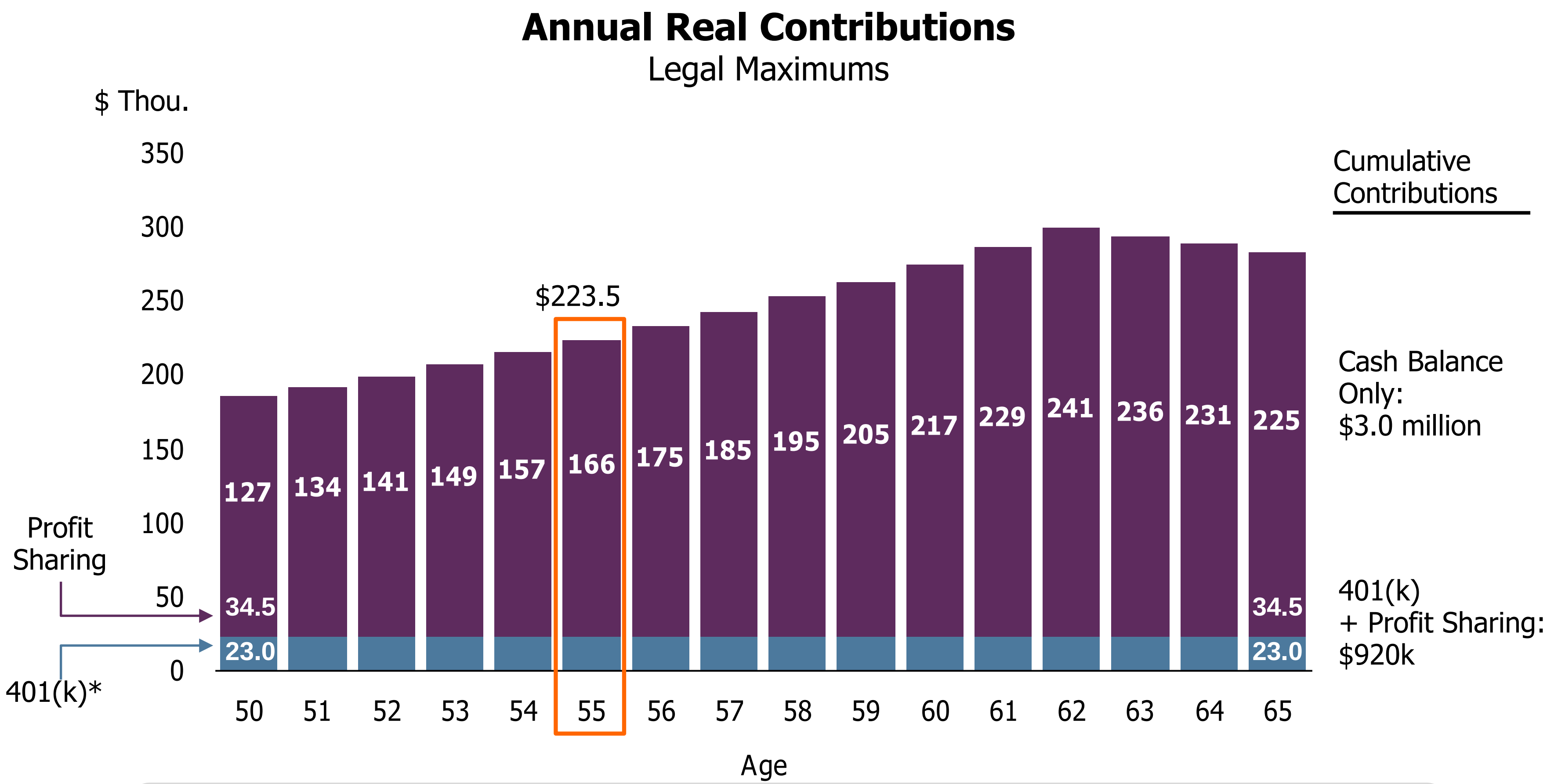
Total Capital Gains & Qualified Dividend Income	$500,000	% of Total	% of Tax Paid
Federal Income Tax	($66,050)	13.2%	87.4%
3.8% Medicare Surtax	($9,500)	1.9%	12.6%
Texas State Income Tax	($0)	0%	0%
Net Remaining After Tax	$424,450	84.9%	



*Sources: IRS, taxfoundation.org, and AllianceBernstein

II. Avoidance Strategy (Pre-Tax Dollars): Maximize Pre-Tax Contributions to Qualified Retirement Plans

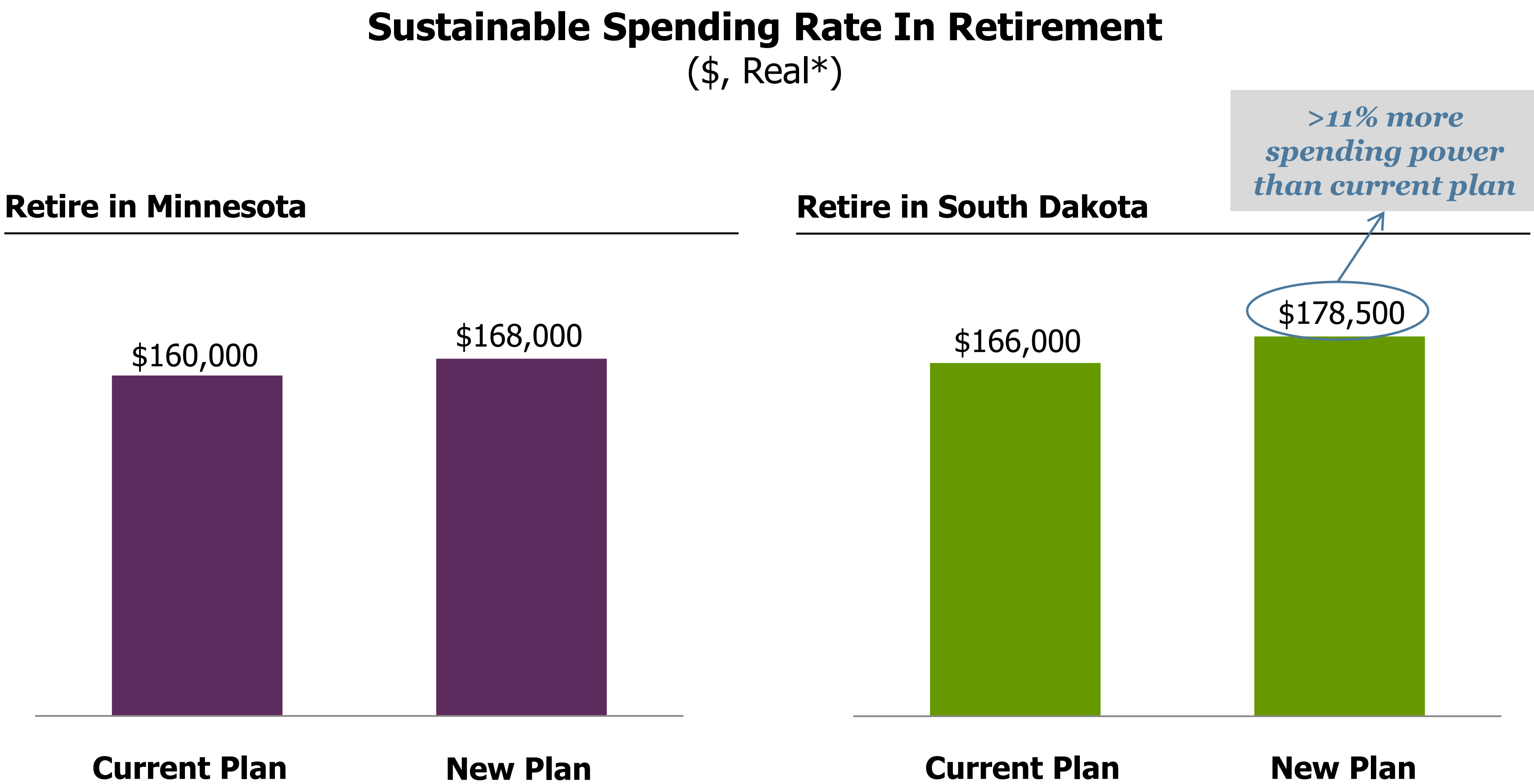
Deferral Possibility for Professionals: Cash Balance Plans



Annual contributions are mandatory and determined for each participant upon entering the plan

*Includes "catch-up" contribution for participants ages 50 and older.
Sources: IRS and AllianceBernstein

New Plan Benefits Significantly From Retiring in Lower Tax Rate State



Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 40 years. Data do not represent past performance and are not a promise of actual or range of future results. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains, ordinary income or losses would be realized that are not reflected here. See Appendix, Notes on Wealth Forecasting System, for details.

*Assumes total after-tax living expenses of $178,500 per year, indexed for inflation in years 1-10 and spending as displayed above in years 11-40. All spending figures are adjusted for inflation. Sustainable spending rate is calculated at a 90% level of confidence. Assumes an investment allocation of 60% global stocks and 40% bonds. "Global stocks" means 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 7% US small and mid cap stocks, 22.5% developed international stocks, and 7.5% emerging markets stocks. "Bonds" mean intermediate-term municipal bonds in taxable accounts and intermediate-term taxable bonds in tax-deferred accounts.

Source: AllianceBernstein

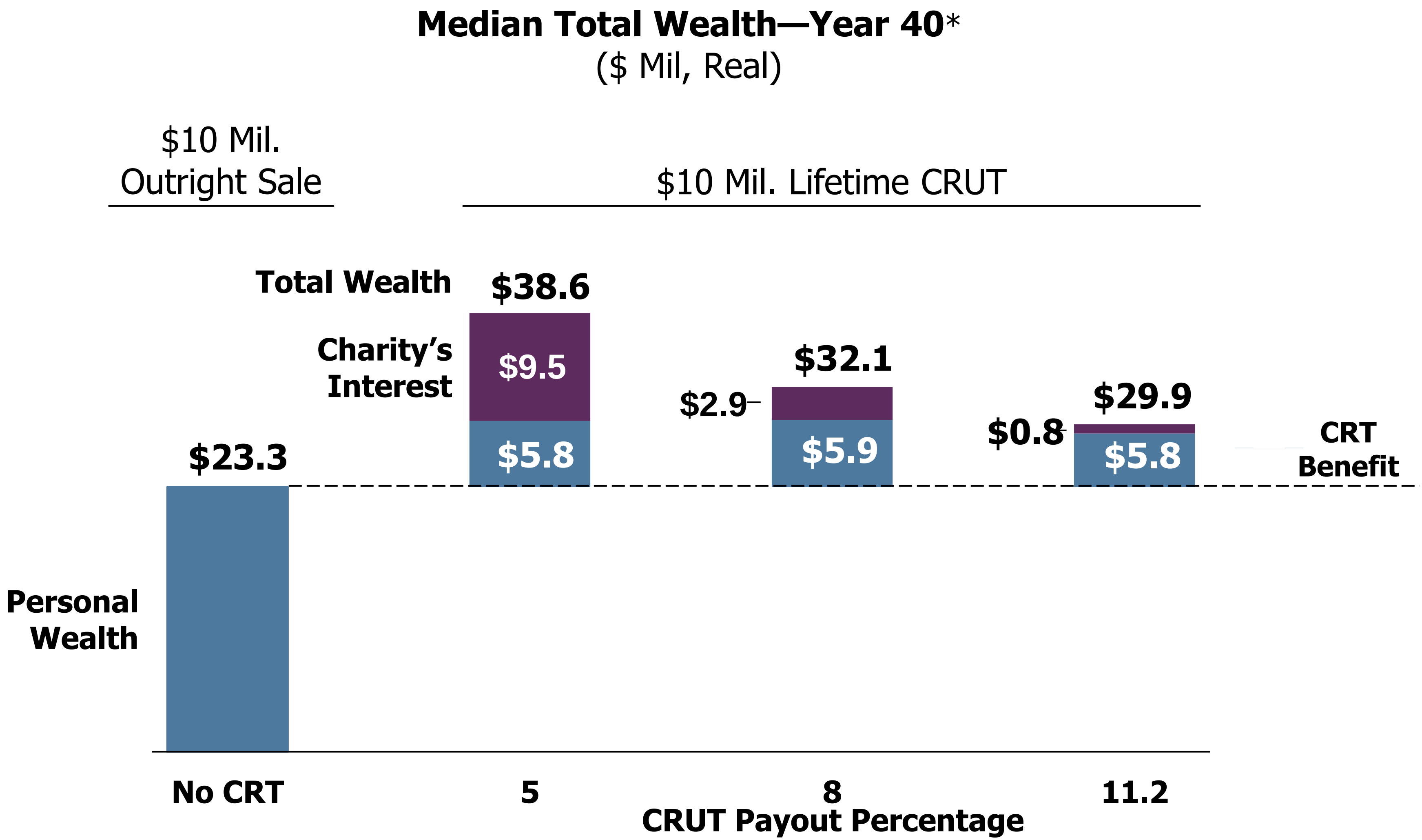
III. Deferral Strategy: Charitable Remainder Trust

Tiered Accounting Rules with Net Investment Income

Category	Class	Rate
Ordinary Income	NII Interest	43.4%
	Excluded Interest	39.6%
	NII Qualified Dividend	23.8%
	Excluded Qualified Dividend	20.0%
Capital Gain	NII Short-Term Gain	43.4%
	Excluded Short-Term Gain	39.6%
	NII Long-Term Gain	23.8%
	Excluded Long-Term Gain	20.0%
Other Income	Tax-Exempt Interest	0.0%
Corpus	Basis	n/a

Source: IRS and AllianceBernstein

Zero-Basis Stock: Over Very Long Horizons, a CRUT Can Enhance Personal Wealth Significantly



*Wealth values include charitable deduction from CRT based upon joint lifetime of two 65 year olds and a section 7520 rate of 2.4%.
Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data do not represent past performance and are not a promise of actual future results or a range of future results. See Notes on Wealth Forecasting System in Appendix for further details.
Source: AllianceBernstein

IV. Income-Shifting Strategy: Aggressively Distribute Trust Accounting Income

Revisiting Traditional Thinking

Dynasty Trust

Traditional Advice

- Don't distribute from a dynasty trust
- Allow assets to grow over time
- Avoid estate tax for as many generations as possible

New Paradigm

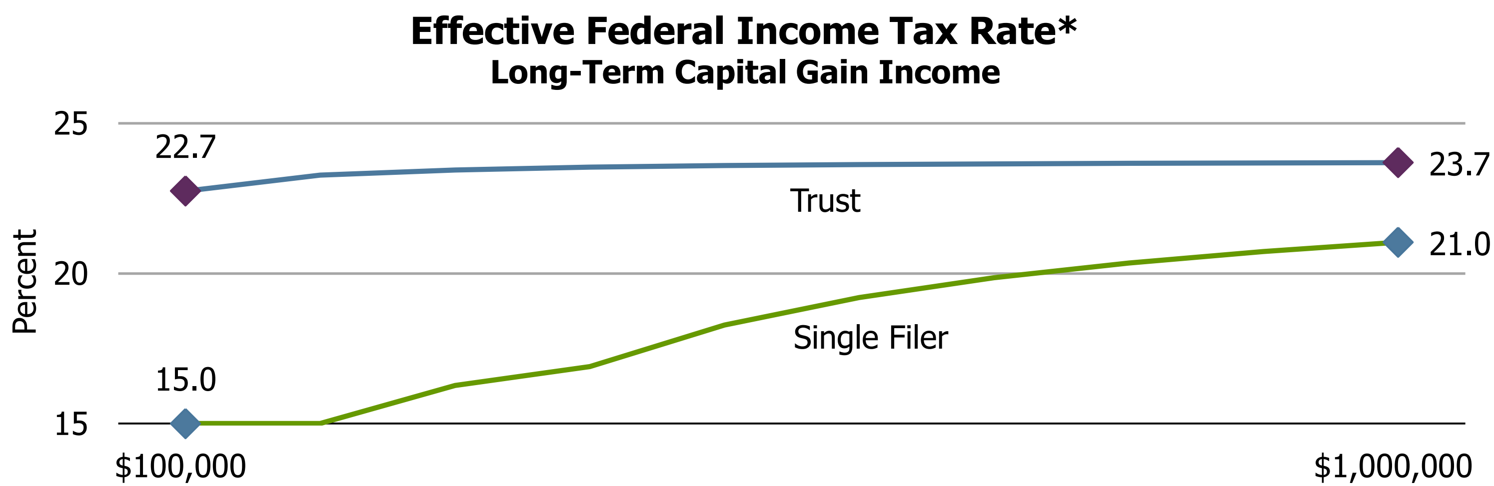
- Could remainder beneficiaries be better off if trust made distributions, avoiding higher tax rates within trust?
- A number of factors may now change the equation:
  - Beneficiary income tax status/situation
  - Trust income tax situation
  - Number of beneficiaries
  - Time horizon

Source: AllianceBernstein

Larger Tax Difference Between Individuals and Trusts Post-ATRA

Dynasty Trust

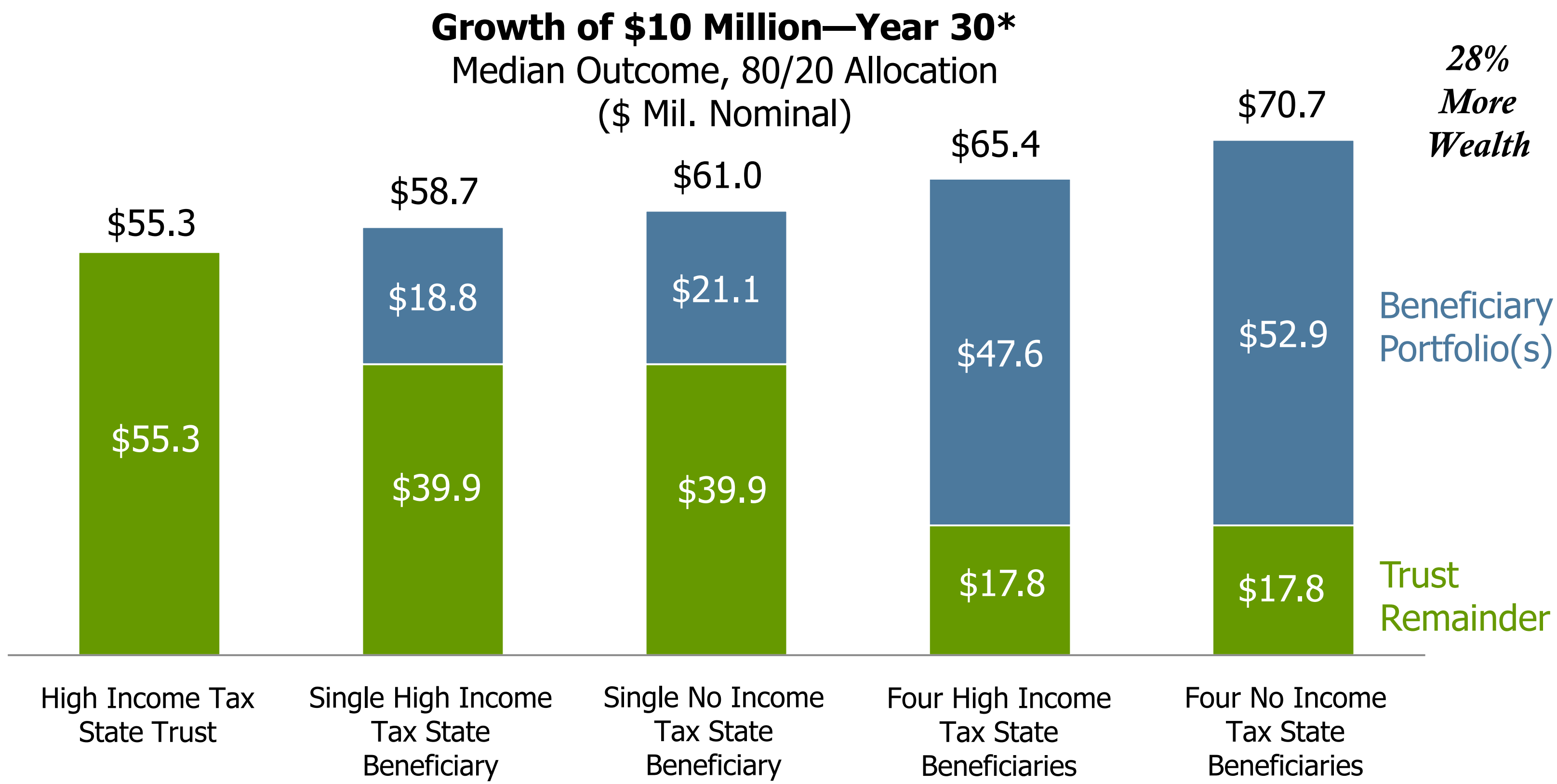
Income Type	Tax Rate	Adjusted Gross Income Threshold	
		Single Filer	Trust
Short-Term Gains and Ordinary Income	39.6%	$406,751	$12,150
Long-Term Gains and Qualified Dividends	20.0%	$406,751	$12,150
Medicare Surtax on Net Investment Income	3.8%	$200,000	$12,150



As of January 2014.
*Effective federal income tax rate is computed assuming the only source of income is the long-term capital gain amount indicated on the x-axis.
Source: IRS and AllianceBernstein

High Income Tax State Trust

Dynasty Trust



No Distributions

Trust Distributes Income to Beneficiaries
Max $250K per Beneficiary**

*80/20 modeled as 80% stocks and 20% bonds. Stocks are modeled as 63% US large-cap, 7% US small-/mid-cap, 22.5% developed international and 7.5% emerging markets stocks. Bonds are modeled as intermediate-term municipals.

**Assumptions: trust distributes pretax annual income and capital gains up to $250,000 per year (nominal) to each beneficiary; beneficiary invests after-tax distributions in 80/20 portfolio. It further assumes each beneficiary has no outside income or other assets and is not subject to estate tax in the future.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. See Notes on Wealth Forecasting System at the end of this presentation for further details. **Data do not represent past performance and are not a promise of actual future results or a range of future results**.

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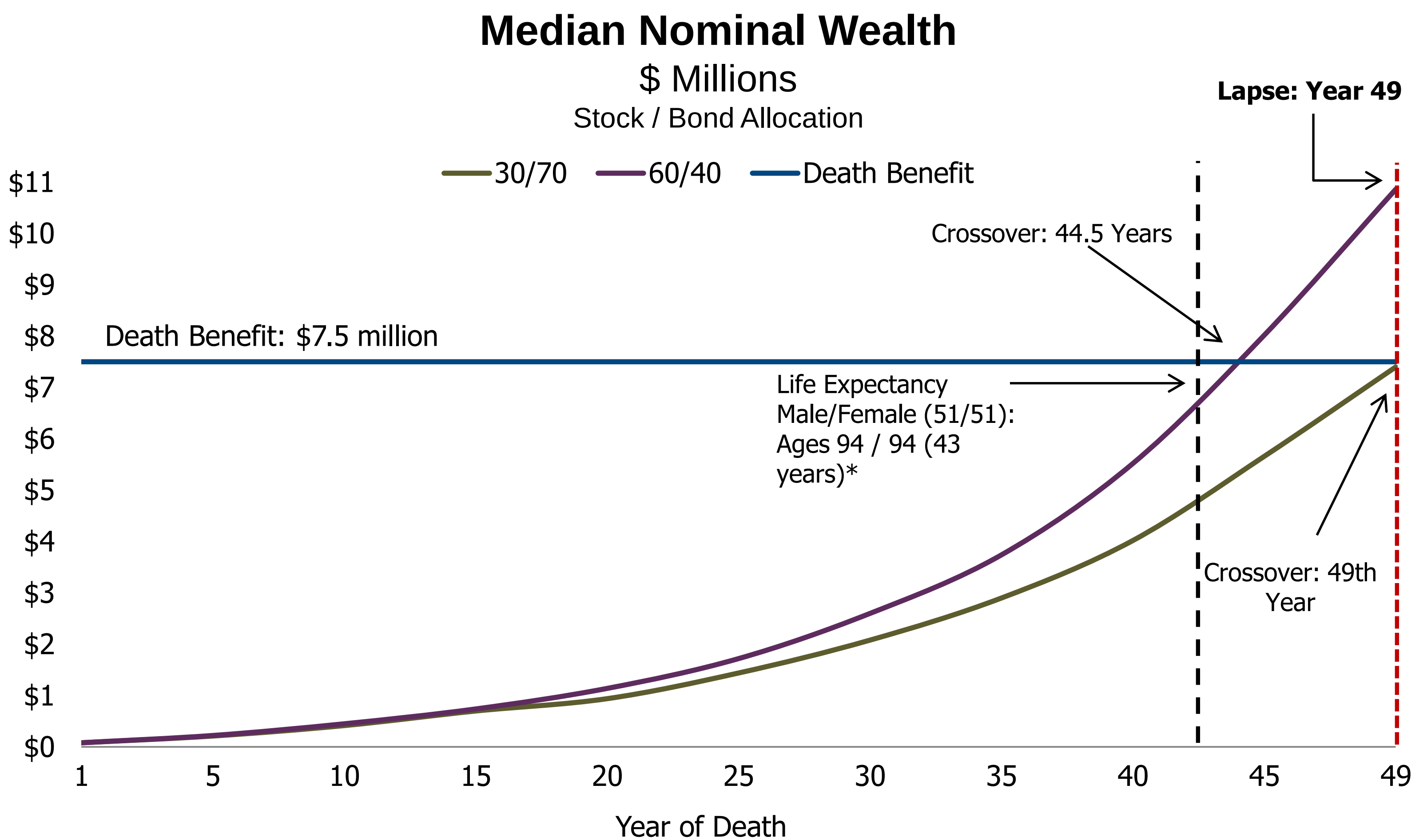
V. Avoidance Strategy (After-Tax Dollars): Life Insurance—But Mostly Because I Think This Is Cool

What a "Healthy" Policy Looks Like

Original Illustration 5



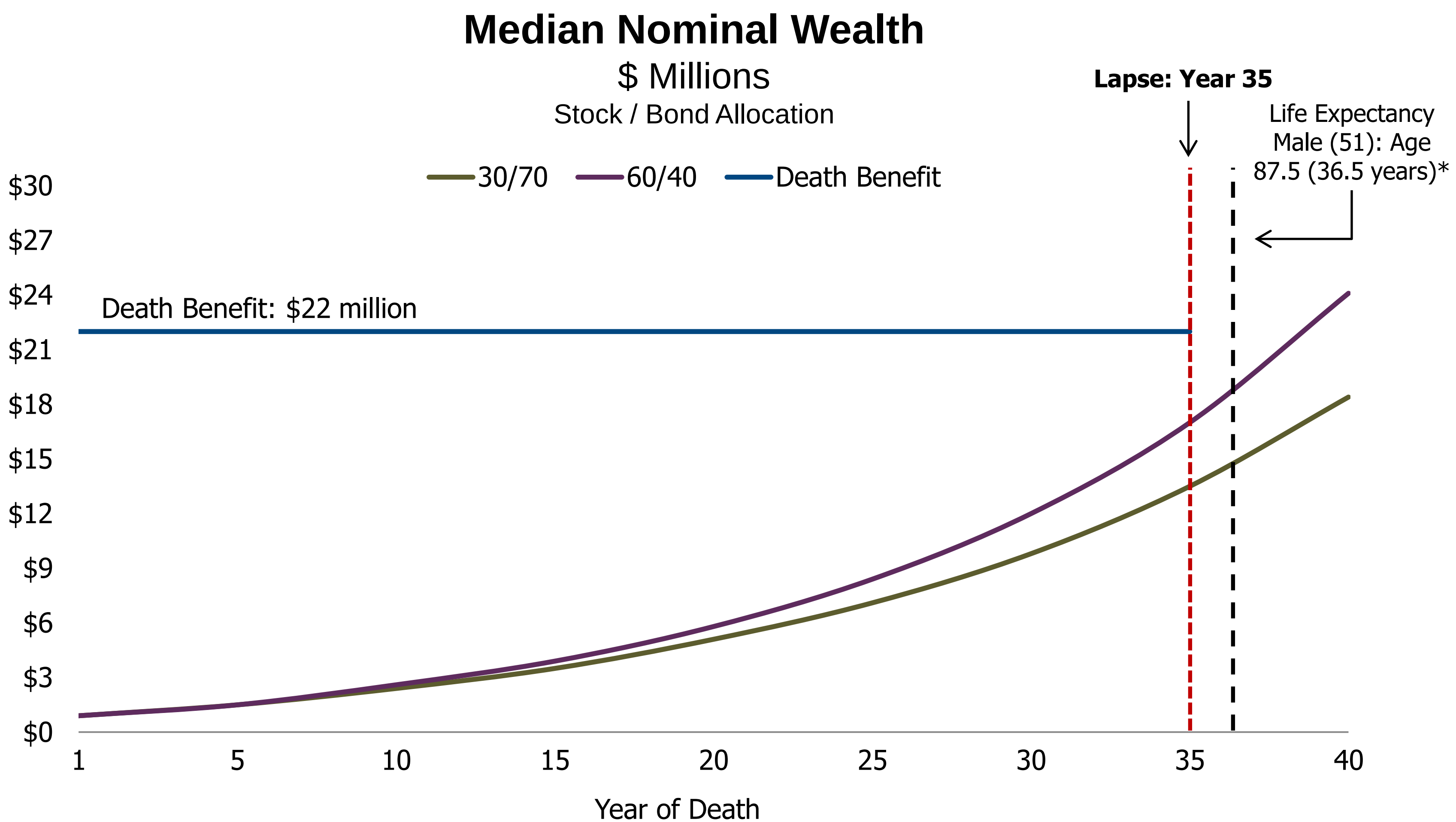
Initial value of portfolio is assumed to equal the cash surrender value of $50,352. The annual premium of $28,005 is assumed to be invested in a 30% globally diversified equity and 70% intermediate-term municipal bond (30/70) portfolio and 60% globally diversified equity and 40% intermediate-term municipal bond (60/40). No taxes have been modeled throughout the analysis as the funds are assumed to be invested in a grantor trust. In addition, we adjusted the value of the trust to account for the impact taxes will have on the grantors portfolio and the reduced amount the beneficiaries will receive.

*HNW male/female couple, nonsmokers, ages 51/51: 43 years (ages 94/94) *Source: Bernstein estimate derived from mortality tables developed for high-net-worth couples. See Harold D. Skipper and Wayne Tonning, The Advisor's Guide to Life Insurance 346 (2011).

Based on Bernstein's estimates of range of returns for applicable capital markets over the applicable period. Data do not represent past performance and are not a promise of actual results or a range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

What a "Sick" Policy Looks Like

Original Illustration 2



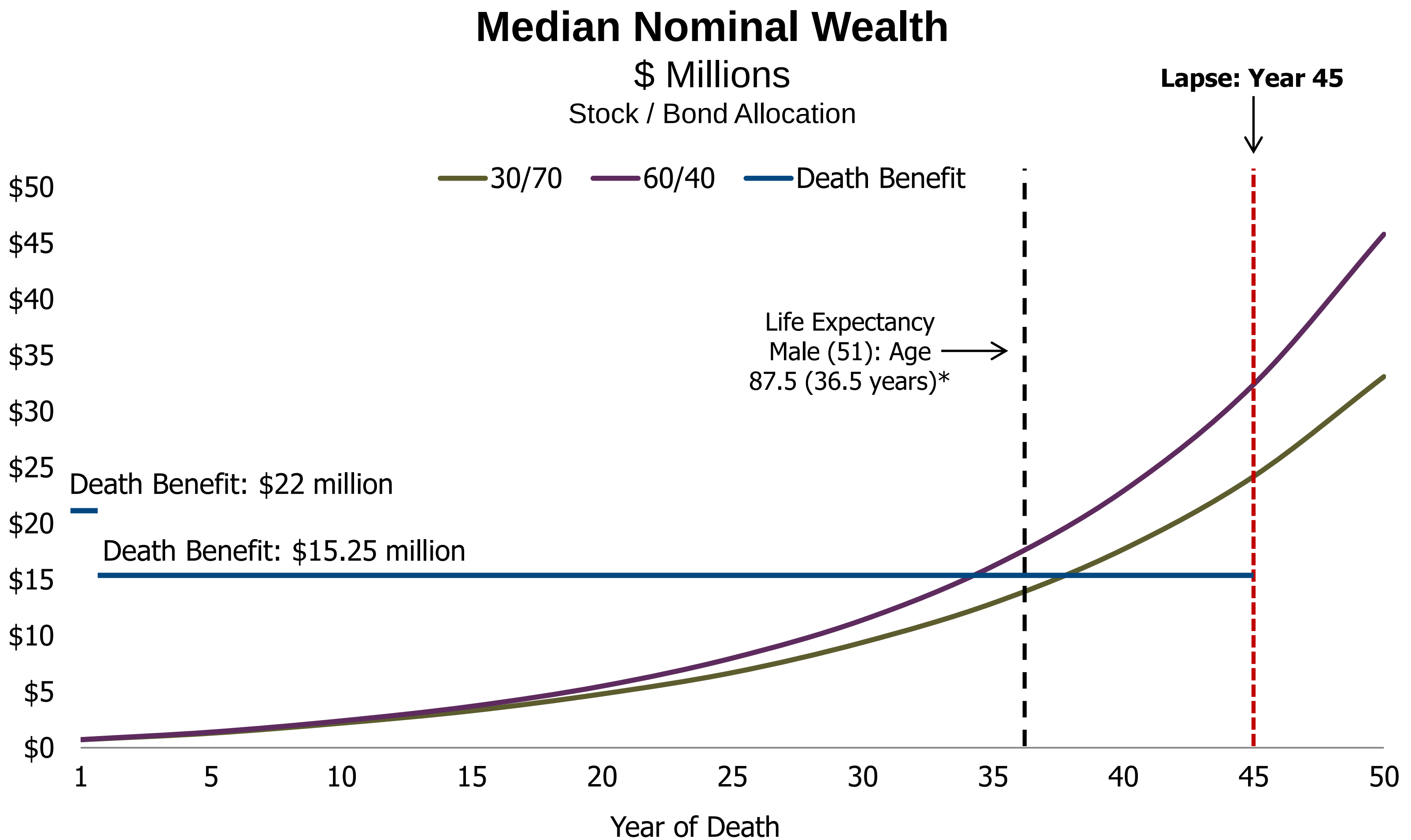
Initial value of portfolio is assumed to equal the cash surrender value of $708,317. The annual premium of $114,350 is assumed to be invested in a 30% globally diversified equity and 70% intermediate-term municipal bond (30/70) portfolio and 60% globally diversified equity and 40% intermediate-term municipal bond (60/40). Top marginal federal tax rates and Arizona state tax rates have been modeled throughout the analysis.

*HNW male, nonsmoker, age 51: 36.5 years (age 87.5) *Source: Bernstein estimate derived from mortality tables developed for high-net-worth individuals. See Harold D. Skipper and Wayne Tonning, The Advisor's Guide to Life Insurance 337 (2011).

Based on Bernstein's estimates of range of returns for applicable capital markets over the applicable period. Data do not represent past performance and are not a promise of actual results or a range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

How to Make a "Sick" Policy "Healthy"

New Illustration 2d

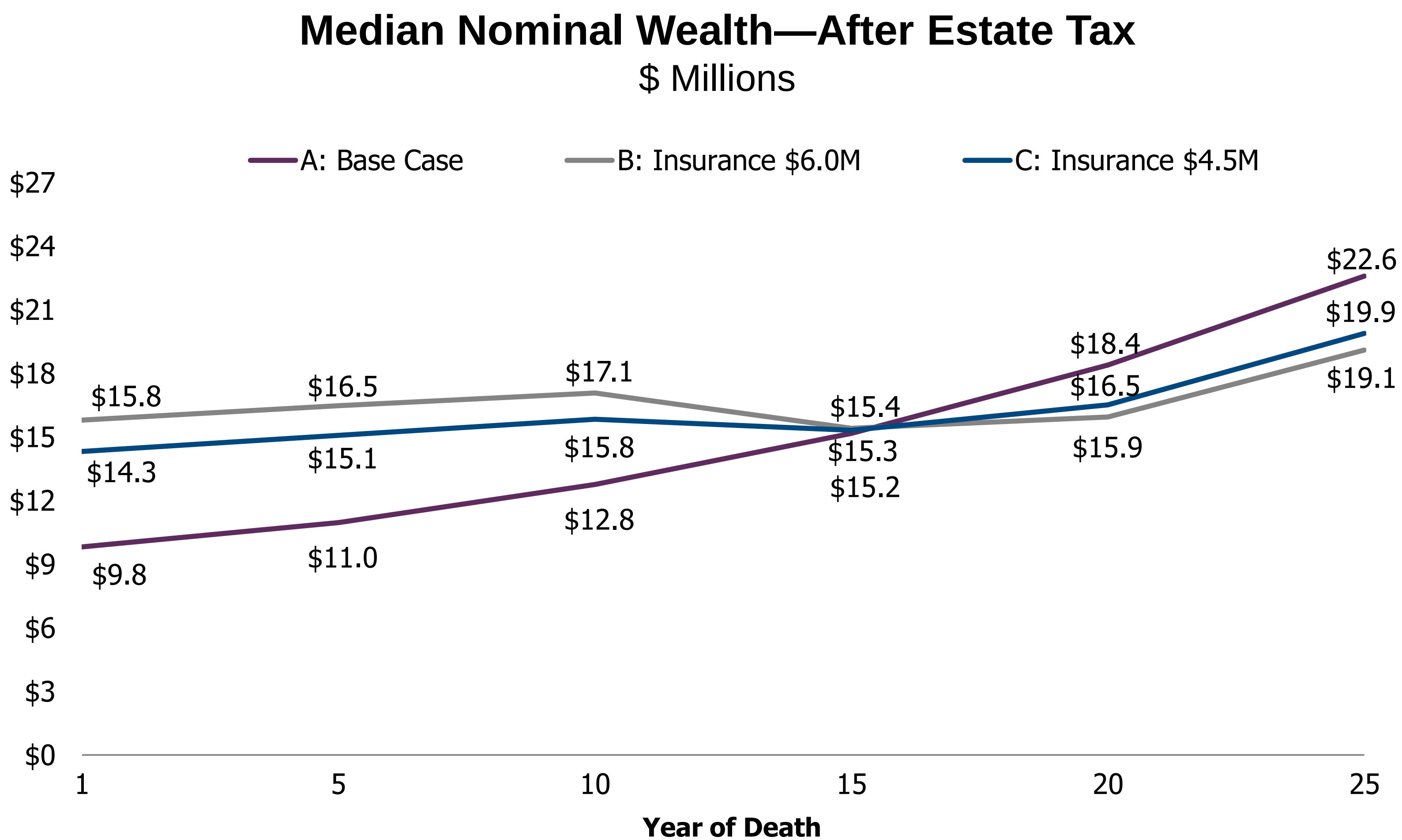


Initial value of portfolio is assumed to equal the cash surrender value of $691,260. The annual premium of $114,350 is assumed to be invested in a 30% globally diversified equity and 70% intermediate-term municipal bond (30/70) portfolio and 60% globally diversified equity and 40% intermediate-term municipal bond (60/40) from 2015 - 2063. Top marginal federal tax rates and Arizona state tax rates have been modeled throughout the analysis.

*HNW male, nonsmoker, age 51: 36.5 years (age 87.5) *Source: Bernstein estimate derived from mortality tables developed for high-net-worth individuals. See Harold D. Skipper and Wayne Tonning, The Advisor's Guide to Life Insurance 337 (2011).

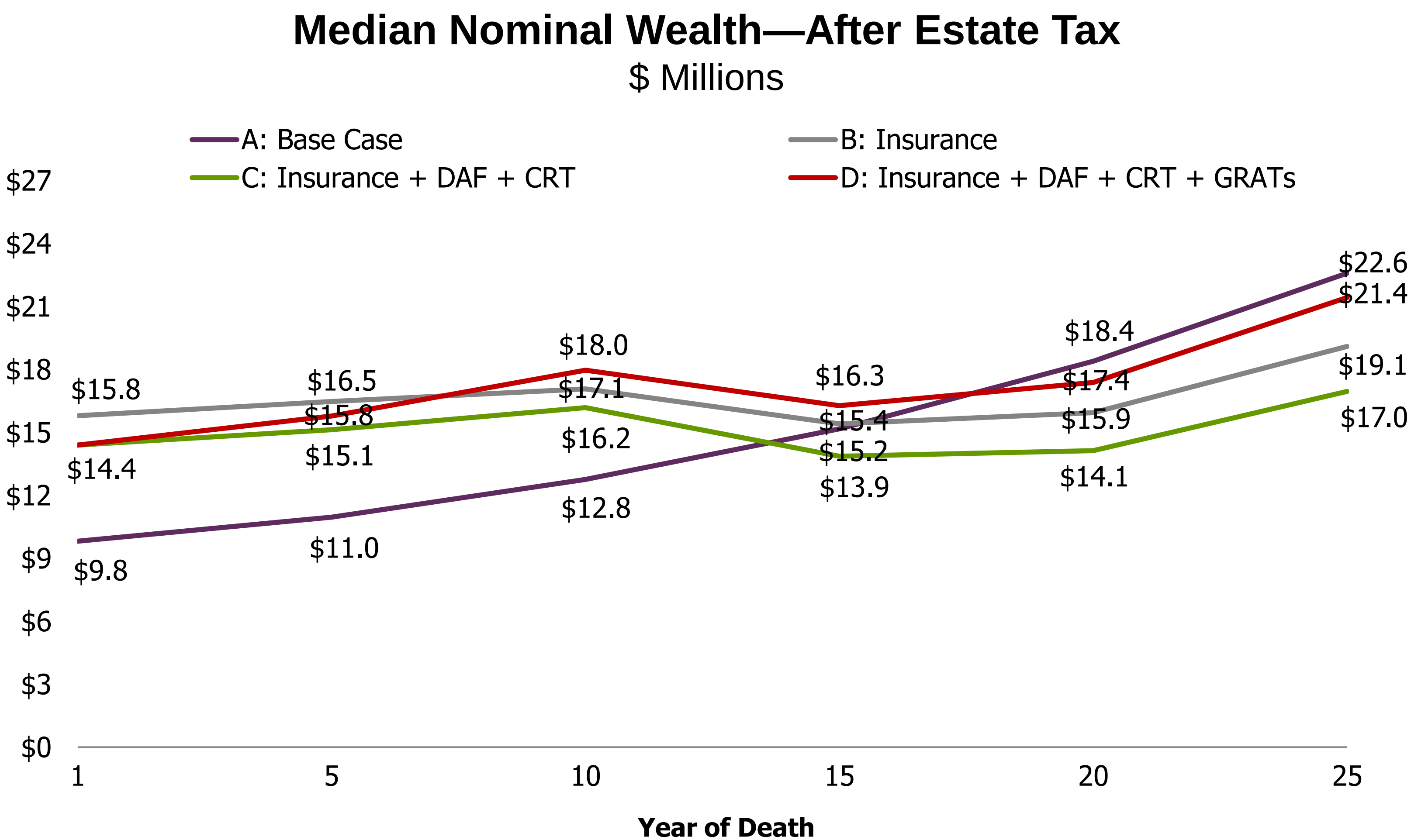
Based on Bernstein's estimates of range of returns for applicable capital markets over the applicable period. Data do not represent past performance and are not a promise of actual results or a range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

"Right-Sizing" the Insurance–Flattening the Curve



The total wealth in each year represents the combined value of Mrs. Client's estate after estate tax, any assets held in the IDGTs, and any life insurance proceeds. The life insurance proceeds have only been modeled in scenarios B and C. In scenario B, we modeled three $2 million term policies ($6M total) with terms of 10, 10 and 15 years. In scenario C, we modeled three $1.5 million term policies ($4.5M total) with terms of 10, 10 and 15 years. The annual premiums for these policies in scenario B (and C) are assumed to be paid by the ILIT in the amount of $25,030 ($18,773) for 10 years, $30,159 ($22,619) for 10 years, $34,750 ($26,063) for 15 years.
A federal estate tax rate of 40% was applied to any assets remaining in the Mrs. Client's estate in the year of death. It is assumed that the Mrs. Client has $4 million of her application exclusion amount remaining as of 2014.
Based on Bernstein's estimates of range of returns for applicable capital markets over the applicable period. Data do not represent past performance and are not a promise of actual results or a range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

Integration of Insurance and Lifetime Wealth Transfer



The total wealth in each year represents the combined value of Mrs. Client's estate after estate tax, any assets held in the IDGTs, and any life insurance proceeds. The life insurance proceeds have only been modeled in scenarios B, C and D from years 1 – 15 with proceeds of $6 million from years 1 – 10 and $2 million from years 10 – 15. A federal estate tax rate of 40% was applied to any assets remaining in the Mrs. Client's estate in the year of death. It is assumed that the Mrs. Client has $4 million of her application exclusion amount remaining as of 2014.

Based on Bernstein's estimates of range of returns for applicable capital markets over the applicable period. Data do not represent past performance and are not a promise of actual results or a range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

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