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MEMORANDUM

**TO:** Mr. Client

**FROM:** Dennis C. Reardon

**DATE:** January 22, 2013

**RE:** Spousal Access Trust/Irrevocable Grantor Trusts  
Income Tax and Estate Tax Implications

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Please refer to the attached memorandum. At the end of the memorandum, I provided a formula to determine the "breakeven" point of a gift to the above-captioned trust. Let me adjust the formula to take into account the minority interest discount that will apply to your gift of nonvoting stock to the trusts. First, for easy reference, let me use the same hypothetical values shown in the memorandum, adjusted by the 35% minority interest discount.

**Issue:** How much growth must be achieved so that estate tax savings will at least equal income tax costs?

Assumptions:

Fair Market Value of Asset:	\$1,000,000
Minority Interest Value of Asset:	\$650,000
Basis of Asset:	\$400,000
Capital Gains (Sale After Death):	\$600,000
Estate Tax Rate:	40%
Capital Gains Tax Rate:	23.8%

If the fair market value of asset is \$1,000,000 and the minority interest discount is 35%, then the fair market value of the minority interest is \$650,000.

If, instead of an asset having a fair market value of \$1 million, that asset is transferred as a gift which qualifies for a 35 percent minority interest discount, the value of the gift would be \$650,000. (For the sake of example, we're treating the minority interest in isolation — as if the majority interest is covered in a separate calculation.) That would result in applying the same formula except that \$650,000 would be the point from which growth would be measured, as follows:

Solve for Amount of Growth to Breakeven:

$X = \text{Amount of Growth (in Excess of \$650,000)}$

$$\begin{aligned} .238(\$250,000 + X) &= .4X \\ \$59,500 + .238X &= .4X \\ \$59,500 &= .162X \\ X &= \$367,284 \end{aligned}$$

Value of Gift	\$650,000
Growth	<u>\$367,284</u>
Breakeven Point	\$1,017,284

The asset would have to grow to \$1,017,284 for the gift to be worthwhile tax-wise, assuming that the asset would be sold after the transferor's death.

Based upon the numbers shown above, with a gift qualifying for a discount, the undiscounted value of the gift (\$1,000,000) need not grow very much. So, the gift provides an estate tax benefit even if limited growth occurs.

We have conferred with Mr. CPA and reviewed our files so that we have developed a reasonably accurate estimation of your income tax basis in the shares of the corporation. (See attached memorandum to Mr. CPA.) It's a good idea to know what the basis of your stock is at this point. Too often, the determination of basis occurs when a person becomes disabled or is in the middle of a transition, otherwise. If Mr. CPA can use the basis number now developed and track it systematically in the future, you'll have a clear picture as to what you would keep after taxes are paid in the event that you sell the company. So, based upon the basis figure that would now apply, we can use the formula to develop a breakeven figure that reflects your actual transaction, rather than a hypothetical illustration.

**Issue:** How much growth must be achieved with respect to the corporation's nonvoting stock so that estate tax savings will at least equal income tax costs?

Assumptions:

Current Pro Rata Value of Nonvoting Stock:	\$5,066,923
Minority Interest Value of 700 Shares of Nonvoting Stock:	\$3,293,500
Basis of Asset:	\$2,224,000
Capital Gains (Sale After Death):	\$2,842,923
Estate Tax Rate:	40%
Capital Gains Tax Rate:	23.8%

The pro rata value of the nonvoting shares is the discounted value (\$3,293,500) divided by the reciprocal of the discount (1 - .35 = .65).

$$\$3,293,500 \div .65 = \$5,066,923$$

If a "round number" estimate of basis of *all* shares is \$4 million, and nonvoting shares are 55.6% of all shares (700 shares ÷ 1260 shares = 55.6%), then the basis of the nonvoting shares is about \$2,224,000 (\$4,000,000 X .556).

Solve for Amount of Growth to Breakeven:

X = Amount of Growth (in Excess of \$3,293,500)

$$\begin{aligned} .238 (\$1,069,500 + X) &= .4X \\ \$254,541 + .238X &= .4X \\ .162X &= \$254,541 \\ X &= \$1,571,241 \end{aligned}$$

Value of Gift	\$3,293,500
Growth	<u>\$1,571,241</u>
Breakeven Point	\$4,864,741

The pro rata value represents the amount of money that you would receive (before taxes) for the nonvoting shares if you sold the company today. The minority interest discount of 35 percent is so valuable that the company need not grow at all for your gift of nonvoting shares to succeed, tax-wise. In fact, the undiscounted value can drop to \$4,864,741 (breakeven point) and you'll still break

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even. If it doesn't grow at all (and doesn't lose value either), your family would still be ahead if you died and the company is sold at its current value.\*

Income Tax Aspect		Estate Tax Aspect	
Sale Proceeds	\$5,066,923	Pro Rata Value	\$5,066,923
Basis	\$2,224,000	Value of Gift	\$3,293,500
Taxable Gain	\$2,842,923	Discount	\$1,773,423
Capital Gains Rate	<u>X .238</u>	Estate Tax Rate	<u>X .4</u>
Capital Gains Tax	\$676,616	Estate Tax Saved	\$709,369
	Estate Tax Savings	\$709,369	
	Income Tax Cost	<u>\$676,616</u>	
	Overall Tax Savings	\$32,753	

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\*The comparison shown is based upon the assumption that stock would be sold. An asset sale would involve a different calculation.