

Five Strategies That Reduce Capital Gains Taxes on Highly Appreciated Real Estate

Advanced Strategies That Can Solve a Variety of Tax Planning Issues

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Abstract: *In working on strategies to help defer, mitigate, or reduce capital gains taxes on real estate investments, clients generally consult with a single advisor who has one or two main ideas to offer. That same client would end up with a handful of relevant and perhaps better suited Internal Revenue Code-sanctioned strategies if given the opportunity to surround him/herself with an attorney, tax preparer, financial planner, and real estate broker, all steeped in the tax strategies in their respective disciplines, or a single advisor with a broader approach to managing a variety of taxes. Regardless of whether a client is using a team approach or a single, well-rounded advisor, what follows are strategies that should help clients with a greater number of options.*

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Of all the asset classes used to grow and preserve wealth, investment real estate could very well be the most underrepresented in terms of investor knowledge and professional guidance. In particular, strategies to help offset taxes on the sale of highly appreciated real estate could be the most misunderstood, potentially resulting in a high cost to the investor. To appreciate the significance of this gap, it's important to get a refresher on real estate taxation.

Taxes on the sale of an appreciated real estate investment fall into three different and overlapping categories:

1. **Ordinary income tax.** Different from the taxes taken against unsheltered income on the sale of investment real estate, accelerated depreciation taken on personal property and land improvements is recaptured at the taxpayer's marginal tax rate.¹ Federal and state taxes apply.
2. **Federal capital gains tax.**² The current federal capital gains tax is 15%, scheduled to increase to 20% in 2013. Most states add their own versions of capital gains tax, which vary by state.
3. **Recapture tax.**³ Also known as unrecaptured Section 1250 depreciation, a 25% tax attributable to certain straight-line depreciation taken during the life of the investment.

It is important to note that if the disposed or sold property was acquired as a result of a 1031 deferred exchange, then the capital gains and recapture taxes apply from the original property. In this instance, calculating taxes based only on information on the disposed property would be an underestimation of total taxes due.

Meet the Grimeses

To illustrate these taxes, and eventually a few of the strategies that can be used to offset these taxes, we will examine the case of Mr. and Mrs. Grimes. Both are age 70 and in reasonably good health; their current estate of \$22 million consists mostly of commercial real estate. California residents, their marginal tax rate is 35% (federal) and 9.6% (state). The Grimeses have been approached to sell one of these properties to a redeveloper. Details on this particular sale are:

- Property: Industrial building in central California
- Entity: Central Valley LLC
- Owners: The Grimes Family Revocable Trusts
- Adjusted cost basis: \$3 million
- Debt: None
- Sales price: \$5 million in 2011
- Cost recovery taken: \$900,000

Assuming the Grimeses sell their property and take the proceeds without the use of any tax-advantaged strategies, their estimated tax is as follows:

Amount	Type	Calculation
\$0	Ordinary income tax	No facts provided
\$270,000	Capital gains tax	$\$1,100,000 \times 24.6\%^4$
\$225,000	Recapture tax	$\$900,000 \times 25\%$
\$495,600	Total taxes	
\$4,504,400	Proceeds from sale	

Not factoring into the calculation taxes paid on income generated during the 10-year holding period,⁵ the total of the recapture and capital gains taxes are just under \$500,000. Assuming that the cash flow during the holding period of this investment was favorable, taxes taken on its sale will reduce the total return. An opportunity exists to strengthen this return rate and place a higher amount of proceeds to work if the family uses any one or more of a handful of strategies available to most taxpayers in the same position.

The Advice Challenge

Because it is difficult for many tax advisors to hold an understanding of the most current investment, tax, and legal strategies, it becomes a challenge to have all strategies at their fingertips.

Real estate professionals (brokers, mortgage profes-

sionals, exchange intermediaries) lean heavily on their training and experience, which is transaction-based. This bias is generally not intentional; like other professional advisors, the broker community does not tend to have access to this type of education or training.

Because their business model is largely based on assets under management, financial planners and advisors tend to understand the least as a consultant class about directly held real estate tax strategies. This group of advisors tends to work more with real estate investment trusts, which are securities sold by prospectus, and require a vastly different approach to acquisition, disposition, and taxation than directly held commercial real estate.

Five Strategies

With a spotlight on only tax strategies that can be found in the Internal Revenue Code, not covered in this article are tax loopholes and other gray market approaches to reducing taxes that can occasionally trip up advisors and their clients. Five IRS-sanctioned strategies include: the 1031 Tax-Deferred Exchange, the 1031-721 Tax-Deferred Exchange, irrevocable trusts, tax-advantaged investments, and traditional tax planning.

The 1031 Tax-Deferred Exchange⁶

The 1031 Exchange, also known as a “Starker” Exchange, is generally understood at a high level by most professional advisors. It is also the most popular strategy employed by real estate brokers. For that reason, it is known by most serious real estate investors. If executed within the IRS guidelines, the 1031 Exchange allows an investor to exchange from one investment property to another while deferring capital gains and recapture taxes.

In the example of the Grimes family, rather than taking the \$495,600 tax on the sale of their light industrial property, they could transfer the entire \$5 million into their next real estate investment, assuming that this move is consistent with their goals for income, tax, and estate planning. Assuming a 7% rate of return on any investment decision, the income generated by the exchange could generate \$350,000 of income from an investment base of \$5 million rather than the \$315,308 of income from the net of tax investment base of \$4,504,400. When you consider that the cost-recovery schedule starts

fresh on an exchange, the tax shelter from the exchange would generate an even greater tax-equivalent dividend.

Any type of real estate held for business purposes is eligible, including single-family rentals, commercial real estate, and land. What makes this intriguing for investors is that it is possible to continue to exchange during the life of an investor and then, if titled properly, pass along the property to beneficiaries on a stepped-up basis without ever having to pay capital gains taxes. These comments assume the current estate tax law, which is scheduled to sunset on December 31, 2012. It is unclear how legislative changes might change the use of this strategy.

It is possible to partially exchange the Grimes property, and pay “boot”⁷ on the unexchanged portion of the transaction. This approach allows an investor to take some liquidity and pay corresponding taxes, and defer taxes on the balance. It is important to note that paying “boot” is not a prorated tax calculation. When paying boot, taxes tend to be front-loaded. It is possible that at some percentage of the transaction, it makes equal sense to pay taxes on the entire amount of the sale rather than paying almost all taxes on half the sales. While the current capital gains rates are currently at historic lows, this could be a suitable strategy for some investors.

Comments on 1031 Exchanges

The dramatic ascent of 1031 Exchanges and tenants-in-common (TIC) properties in the early 2000s has caused most investors to use these terms interchangeably. TICs are not a tax strategy. Rather, they represent a form of ownership that can satisfy as the replacement property required in a 1031 Exchange. Over the last few years the TIC market has been tarnished due to a good number of properties where proper due diligence was lacking. This lack of review of the feasibility, sustainability, and risk associated with the investment is responsible for substandard performance for some properties, and loss of investment capital with others. As a result of the confusion between these two terms, investors and advisors have become unnecessarily concerned about 1031 as a suitable strategy. The 1031 Exchange still offers value to the right type of investor.

1031 Exchanges are not free from risk. In addition to the risk of the new investment, there is also the risk of

not satisfying the IRS requirements and safe-harbor rules and failing the exchange altogether. It is important that investors work closely with a team of professional advisors to make sure that this strategy is suitable and that all IRS requirements are understood and met.

The Lesser-Known 1031-721 Tax-Deferred Exchange⁸

Frequently investors interested in exchanging a directly held property ask, “Would an exchange into a real estate investment trust (REIT) qualify for tax deferral under a 1031 Exchange?” The short answer is no. But with the recent interest in this option, an older strategy requiring some planning can qualify for an exchange into an REIT.

Some institutional REITs utilize Section 721 as a way to acquire property directly from real estate investors interested in selling but who wish to defer capital gains taxes, diversify their holdings, and relinquish management responsibilities as part of a 1031 Exchange. Rather than exchanging one piece of real property for another, or for a fractional interest in a TIC, IRC Sec. 721 allows an investor to contribute property directly to an REIT’s operating partnership in exchange for operating partnership units (or ownership). This type of transaction is commonly referred to as a 1031-721 Exchange or UPREIT transaction. The benefits of this particular strategy include:

- The potential to exchange into a geographically diversified portfolio
- A less volatile and more predictable stream of income as a result of the diversification
- The potential to exchange into institutional-quality real estate
- Passive management
- Deferral of capital gains (the original goal)
- Potential use to help with estate planning

This is a nice idea. But when this is played out, the reality is that most directly held properties are not complementary to the investment objectives of a Class-A commercial REIT. Most investors own single-family homes or small commercial buildings. A \$20 million building will not capture the interest of an institutional REIT that regularly buys and sells \$100 million proper-

ties. To satisfy this gap and increase funds into their REITs, a few REIT sponsors offer a process to help exchange a single-family home or farmland into their REIT. This starts when the REIT identifies one of its properties from the current portfolio and holds it out as a TIC available for investors to purchase a fractional interest. While it is temporarily outside the REIT, it attracts 1031 Exchanges from smaller property owners. When the property is fully subscribed, it is closed and managed by the REIT sponsor for the benefit of its investors for about three years. During this time, investors receive cash flow and tax write-offs generated by the property, much like they might receive from any other replacement property. Following the third year, the REIT sponsor intends to bring that property back into the REIT where it originated. When that happens, the investor exchanges his/her share of ownership for units in the REIT, effectively owning a smaller portion of all properties in the REIT and benefiting from the tax-advantaged income.

In the case of the Grimes family, assuming for this analysis an annual 7% dividend on all investment decisions including REITs, they are able to transfer their \$5 million investment base for a cash flow that, when it is brought into the REIT, would produce cash flow from a larger number of properties across the country than exchanging into a single directly held property or TIC. When the REIT liquidates through an initial public offering, merger, or acquisition, the Grimeses would have the opportunity to keep their shares or sell off any part of their REIT ownership and pay taxes only on the portion sold.

For an estate like the Grimeses', this strategy offers the additional benefit of potential estate tax savings and liquidity. At \$22 million, assuming current estate tax law, the Grimeses have an estate subject to 35% tax for everything over the \$10 million exemption. Because the \$5 million in this particular scenario is not liquid or marketable, it is subject to discounting, which would help reduce their taxable estate. The percentage of discounting is subject to the circumstances, but could potentially help reduce their estate-taxable \$5 million property anywhere from 20% to 40%.

The 721 strategy can also turn out to be an ideal

estate distribution strategy. Rather than the beneficiaries needing to agree to keep or liquidate the property, the units could be distributed per the Grimeses' wishes with each beneficiary having the opportunity to hold or sell his/her units without affecting the other beneficiaries. If properly titled, these units can also receive a stepped-up cost basis. The flexibility of this strategy is suited to additional estate planning techniques, such as the current \$5 million lifetime gift exemption and generation-skipping transfer tax strategies.

Tax-Advantaged Investments

Assuming that the government continues to support the cultivation of natural resources in the United States, qualified oil and gas drilling programs can provide significant tax benefits for someone seeking to offset taxes on highly appreciated assets like real estate, directly held businesses, or stock positions. My experience in working with even the most sophisticated real estate investors is that there tends to be confusion or misinformation about this strategy. For this reason, it's important to start with what oil and gas drilling is not.

- It is not "wildcatting." The award-winning movie *There Will Be Blood* starring Daniel Day-Lewis is a dramatic, early-day depiction of wildcatting. Wildcatting involves drilling or prospecting an experimental oil or gas well in an area not known to be productive. It entails a high level of risk and reward and is not suited for most investors.
- This strategy does not involve owning land for oil, gas, and coal royalties.⁹ It is possible to 1031 Exchange into this type of investment because land is considered exchangeable. But this strategy essentially results in a return of capital over a 10-year period, which, in my experience, is not exactly income that investors expect. While there is generally a return of capital over this time, the main benefit of this strategy is that there is a potential to recover what would otherwise be capital gains tax.

The tax-advantaged drilling program that follows does not include either of the above-referenced strategies. In fact, the percentage of drills to active wells has exceeded 90% for many years. And each fund drills dozens or hundreds of wells. These funds have ulti-

mately generated a great many active wells. Additionally, rather than receiving royalties from oil and gas, this drilling program puts the investor in the position of being a producer and seller, generating income from the sale of this commodity.

The benefits to qualified drilling programs include the following:

- A write-off on a significant amount of the initial investments against all income or gains for that same tax year. Typically, 89-91% of the investment made is allocated to intangible drilling costs¹⁰ and can be written off entirely in year one, having the potential for investors to shelter nearly all capital gains tax incurred on the sale of a highly appreciated asset.
- Tax-advantaged income for the life of the program. Income generally starts in year two after the first group of wells drilled has produced oil or gas that has been barreled and sold. The wells maintain fairly high yields for the first five years. This market is not subject to the behavior of stocks and bonds. Rather, it is an investment partnership involved in the production of oil and gas and is subject to what that commodity will fetch in the open market. Because of the life cycle of an oil well, production generally peaks around year five, and thereafter decreases over dozens of years like a slowly leaking balloon.
- A return of investment target date of five to six years. A combination of the tax deductions and tax-advantaged income generally result in a return of the original investment by year six. This is important for investors to understand because, due to the aggressive tax write-off and sheltering, the investment capital is not returned to investors. This can be unsettling to real estate investors who are accustomed to seeing their investment base appreciate over time. But generally explaining the numbers and the concept of return of capital resolves this anxiety.
- A considerable discount for estate planning. Because the capital is not returned, it is out of the investor's estate forever. This results in a reduction on the taxable estate by the amount of the investment. However, estate tax applies to the income, which is generally calculated as multiples of the then current

annual cash flow. In general, because of the illiquidity of this investment, the loss of investment capital, and a discount for marketability of the income, this strategy can help reduce a family's estate.

As this applies to the Grimes family, let's assume that they decide not to participate in an exchange and instead choose to invest \$2 million of their \$4,504,400 into a qualified oil drilling program. With a marginal tax rate at 44.6%, assuming a 90% first-year write-off due to intangible drilling costs,¹¹ the estimated tax savings is \$802,800 (\$1.8 million Form 1040 Line 17 deduction multiplied by 44.6%). This leaves a net tax credit from the sale of the original \$5 million property of \$307,200 (original \$495,600 capital gains due minus the \$802,800 in savings due to the tax deduction). The Grimeses can also decide to invest less and cover less tax.

Irrevocable Trust Strategies

For some investors, the use of an irrevocable trust to liquidate highly appreciated assets can help satisfy the goal to eliminate capital gains and provide current income from the full amount of capital until death. It is also a method to move assets outside an estate, reduce future estate taxes, and satisfy a charitable intent by contributing the property to a qualified charity. A popular approach for real estate investors is the charitable remainder trust (CRT). At the heart of this strategy, by donating highly appreciated real estate to the CRT, the donor can defer paying the capital gains taxes. To replace the value of the donated asset, some of the trust's current cash flow can be used to purchase a life insurance policy owned by a wealth replacement trust (WRT) for the benefit of the donor's beneficiaries. This policy would be funded outside the estate through gifting and, properly created, would be paid to beneficiaries income tax and estate tax free.

Considerations in the use of a CRT include:

- The current income tax deduction depends on the type of asset donated, the type of charity, and the life expectancy of the beneficiaries.
- Following the sale of the real estate inside the CRT, the proceeds can be used to purchase any type of investment, including more real estate. Advisors should check to understand the impact of unrelated business taxable income (UBTI) to this transaction.

- Income tax deductions not used in the first year may be carried forward for five years.
- The CRT provides a payment stream to the donor while removing management responsibilities.
- There is a restriction on the annual payout from the CRT equal to a minimum rate of 5% and a maximum of 50%.
- The CRT may provide either a level or a flexible payment stream based on the type of trust.
- The donor will likely have to give up control of the investments.

In the case of the Grimeses, they need to decide to execute this strategy before the sale of the property is made or the contract executed. They can transfer their building into a CRT, qualify for an immediate tax deduction the year of the donation and the following five years, and draw income from this trust for what could amount to the balance of their lives. For the highly independent real estate investor, requirements of this strategy could pose challenges, including the loss of control of this asset (although the tax and income benefits are retained) and the time and difficulty to unwind this strategy should the donor change his or her mind.

Other Classic Capital Gains Tax Reduction Techniques

These next two strategies are more common strategies used by most advisors: offsetting gains with losses, and allocation of sales price.

Capital gains and losses can come from a variety of assets, including stocks, bonds, mutual funds, commodities, and real estate. For most people, basis is what they paid for the asset, including transaction costs. While tax harvesting is not an original idea, what does represent opportunity is for an advisor to help his/her client understand the entirety of an investor's financial picture. For some clients, real estate tax decisions are made in a vacuum. Reviewing previous tax returns or current investment tax statements, advisors may find investments in a loss position, or carry-forward losses from an earlier transaction or previous stock market declines.

If the real estate to be sold consists of land, buildings, and personal property, then an opportunity exists to allocate the total sales price by personal property and real

property. Under this approach, sellers will want to allocate as much as possible to land and zero out any ordinary income recapture. In contrast, the buyer will want to allocate as much as possible to depreciable property. In the end, the buyer and seller do not have to agree on their respective allocations.

Getting Real about Taxes

Many investors view taxes as a consequence to avoid at any cost. But when asked what the specific tax is on a potential sale, most are not able to quantify the bill. Dealing with taxes can be more about emotion than finance. In some instances, especially in today's environment where property values are lower in most markets, and considering the current capital gains tax environment, it could be wise to simply pay taxes. But in instances where the amount of taxes saved outweighs the convenience of paying the taxes and starting fresh, these five strategies could be of significant value to clients and their families. ■

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- (1) IRS Code Section 12.45
- (2) IRS Publication 5500.
- (3) IRS Code Section 1250.
- (4) Subject to modest California tax credit allowed for the deduction of federal capital gains taxes.
- (5) Income generated during the holding period was taxed each year, and received during this period as dividends on the investment. Cash flow does not play a part in the taxes paid at the sale of this property.
- (6) IRS Code Section 1.1031
- (7) Although it is not used in the Internal Revenue Code, the term "boot" is commonly used in discussing the tax implications of a 1031 Exchange.
- (8) IRS Code Section 1.721.
- (9) Although the vast majority of 1031 Exchanges involve traditional forms of investment real estate (commercial, industrial, residential, raw land, etc.), according to the IRS Tax Code, certain oil and gas royalties are considered "like-kind" property, and can be eligible for tax deferral benefits of a 1031 Exchange.
- (10) IRC Sections 263(c), 59(e), and Treas. Reg. Section 1.612-4(a).
- (11) IRC Sections 263(c), 59(e), and Treas. Reg. Section 1.612-4(a).

APPENDIX

Five Strategies That Reduce Capital Gains Taxes of Highly Appreciated Real Estate

As advisors consider the suitability of these strategies, a broader view may help illustrate to clients the total impact of each option. This broader view includes the impact of tax-deferred and tax-free income during the life of the investment, the assumed performance of the various investment options, and the treatment of estate taxes of each option.

Working again with the Grimes family case facts, T-charts are a quick way to illustrate these options. They calculate all monies flowing out and when, all earnings flowing in and when, and calculate an internal rate of return (IRR) of these cash flows. Assumptions for these T-chart illustrations for the Grimes family include:

- Assumptions and calculations from main article.
- A 15-year life expectancy for the Grimeses.
- A 44% marginal income tax rate (rounded down, this rate includes the current California state income taxes).
- A 24% capital gains tax rate (rounded down, the current 15% federal plus the current California state tax).
- A 55% estate tax at death (the current 35% rate is scheduled to sunset in 2012, and will reset estate taxes to 2001 levels).
- Unless otherwise noted, investment performance assumed at 7%, net of investment fees and expenses. For real estate investments, this is equivalent to a 7% NOI (net operating income).
- Discounted in real estate income calculations is an assumed growth of income from increases in rent. Assuming these leases increase at the rate of inflation, corresponding increase of expenses would offset most of the rent increase. For the purpose of this article, this is a break-even assumption.
- In the instance of investment real estate, cost recovery assumes depreciable improvements at 70% of purchase price over 27.5 years (the cost recovery schedule for multifamily). This cost recovery will reduce the taxable income from cash flows.
- Capitalization rates (a metric to help provide a quick valuation of commercial real estate) are assumed the same at purchase and disposition.
- To simplify this illustration, costs associated with acquiring or selling real estate are not factored into the calculations. Over 15 years, the absence of these costs will not greatly affect returns.
- Calculations of annual income and dividends are net of estimated income taxes.
- Calculations and results are rounded to the thousands.
- In calculating estate taxes, all assets are "stepped up" and not subject to capital gains taxes at settlement.
- T-charts do not account for the value of reinvesting the income from any of the options. In this regard, the IRR of each option is underreported.

Illustration 1: Sell and Pay Taxes (Scenario 1)

Under this scenario, liquidating the \$5 million real estate and paying recapture and capital gains taxes leaves the Grimes family with net proceeds of \$4,511,000. The proceeds invested at 7% would generate an annual cash flow paid to the Grimeses of \$315,770. Taking a simplified view of the tax treatment of dividends, assuming that all income is taxed at the long-term capital gains rate, taxes on this income are \$75,785. This leaves income net of taxes at \$239,985. In settling this estate, the amount of this asset included in the taxable estate is \$4,511,000. These proceeds are reduced by 55% due to the estate tax, leaving to the estate \$2,029,950 to pass along to beneficiaries. The IRR of the decision to sell and pay taxes is 1.11%. At first glance, the first question is "How could \$4,511,000 in net proceeds with good cash flows generate such a low IRR?" The answer is that while annual cash flows were attractive, estate taxes returned only 45% of the original principal.

Illustration 2: 1031 Exchange (Scenario 2)

Following a tax-free 1031 Exchange, the entire \$5 million is reinvested at 7%. This generates a net operating income of \$350,000. Cost recovery will shelter \$127,000 of this cash flow from income taxes. With total income taxes calculated at \$98,000, income net of taxes is \$252,000. Assuming liquidation of this asset at the time the estate is settled, the gross sales proceeds are \$5 million. These proceeds are reduced by 55% due to the estate tax, leaving to the estate \$2,250,000 to pass along to beneficiaries. The IRR of the decision to sell and pay taxes is 1.76%. Once again, the loss of 55% of the original capital due to estate taxes creates a lower-than-imagined total performance on this option.

1031-721 Exchange (Not Illustrated)

The calculations for this strategy may be more attractive than the 1.76% IRR calculation for the traditional 1031 Exchange. The reason for the variance is due to the potential discounting of the \$5 million asset. Additionally, while in this example cash flow after taxes is similar, this differs during settlement of the estate in that the operating units can be divided by beneficiary. Each beneficiary can then independently decide to retain the asset or sell rather than requiring consensus needed in most cases when distributing real estate assets, or managing the property jointly among families with potentially varying financial objectives.

APPENDIX (cont.d)

Illustration 3: Tax-Advantaged Investments—Oil and Gas Drilling (Scenario 3)

Calculating this option requires a different set of assumptions due to the nature of the investment return, tax benefits, and loss of capital when the investment is made. Those assumptions are:

- Investment base: \$3,020,000 (\$5,000,000 minus net tax savings of \$1,980,000).
- Cash flow base: \$5,000,000 (gross investment).
- Cash flow before tax (CFBT) during years 1 to 5: 10% of investment capital. Since this program provides that 30% of income is tax free, the adjusted average tax rate on all income decreases from 44% to 31%.
- CFBT during years 6 to 15: 6% of investment capital. Since this program provides that 15% of income is tax free, the adjusted average tax rate on all income decreases from 44% to 38%.
- CFBT during years 16 to 20: 5% of investment capital. Since this program provides that 15% of income is tax free, the adjusted average tax rate on all income decreases from 44% to 38%.
- CFBT during years 21 to 24: 3% of investment capital. Since this program provides that 15% of income is tax free, the adjusted average tax rate on all income decreases from 44% to 38%.
- Assumes no additional production after year 24.
- Remainder to estate for settlement purposes is calculated at 5x year 15 income.
- Year 15 cash flow: -\$232,500 (calculated \$186,000 cash flow after tax less \$418,500 for estate taxes).

This may look complicated, but the fact that oil and gas drilling produces higher yields in the beginning and diminishing returns over time and the impact of taxes on this investment explain most of these assumption levels. In this case, the IRR when the assets reach beneficiaries at 4.27% is higher than the tax-deferred 1031 Exchange, even considering the loss of principal at investment.

Irrevocable Trust Strategies (Not Illustrated)

There are too many variations to this scenario and assumptions that need to be made to produce a useful example. But imagine a strategy that allows for the sale of highly appreciated assets without the payment of capital gains taxes that, in many cases, can allow for sufficient cash flow to fund the purchase of life insurance to be paid outside the estate to replace the property transferred to the trust. And these do not factor in all benefits of this strategy. It is likely that, using only the described benefits, the IRR would be higher than the previous three illustrated scenarios. This illustration is done best with a live case and is subject to life insurance underwriting and insurability.

Scenario 1		Scenario 2		Scenario 3	
Investment	-\$5,000,000	Investment	-\$5,000,000	Investment	-\$3,020,000
Year 1	239,985	Year 1	252,000	Year 1	345,000
Year 2	239,985	Year 2	252,000	Year 2	345,000
Year 3	239,985	Year 3	252,000	Year 3	345,000
Year 4	239,985	Year 4	252,000	Year 4	345,000
Year 5	239,985	Year 5	252,000	Year 5	345,000
Year 6	239,985	Year 6	252,000	Year 6	186,000
Year 7	239,985	Year 7	252,000	Year 7	186,000
Year 8	239,985	Year 8	252,000	Year 8	186,000
Year 9	239,985	Year 9	252,000	Year 9	186,000
Year 10	239,985	Year 10	252,000	Year 10	186,000
Year 11	239,985	Year 11	252,000	Year 11	186,000
Year 12	239,985	Year 12	252,000	Year 12	186,000
Year 13	239,985	Year 13	252,000	Year 13	186,000
Year 14	239,985	Year 14	252,000	Year 14	186,000
Year 15	239,985	Year 15	252,000	Year 15	-232,500
Year 16	2,029,950	Year 16	2,250,000	Year 16	155,000
Year 17		Year 17		Year 17	155,000
Year 18		Year 18		Year 18	155,000
Year 19		Year 19		Year 19	155,000
Year 20		Year 20		Year 20	155,000
Year 21		Year 21		Year 21	93,000
Year 22		Year 22		Year 22	93,000
Year 23		Year 23		Year 23	93,000
Year 24		Year 24		Year 24	93,000
IRR	1.11%	IRR	1.76%	IRR	4.27%

The scenarios illustrated above are designed to provide perspective to advisors and taxpayers on the total impact of income, capital gains, and estate taxes, and should not be interpreted as advice to any specific client or a preference for any particular strategy. Actual results will vary. Professional advisors should be consulted when making these assumptions and illustrations.