<u>Exhibits re 2022 Annual Letter</u>

<u>EXHIBIT A</u>

a. <u>Corporate Transparency Act (CTA)</u>. The Corporate Transparency Act becomes effective as of January 1, 2024. This new law requires all "reporting companies" to file a report about the company, certain "beneficial owners" and company applicants with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FINCEN). This will require people who control private LLCs, limited partnerships and corporations (but not general partnerships) to start filing reports with the federal government about their ownership.

i. <u>"Reporting Company" Definition</u>.

i. For <u>domestic (U.S.) companies</u>, this definition includes any corporation, LLC, or other entity (such as LPs, LLPs and business trusts) created by the filing of a document with the Secretary of State or similar office.

ii. For <u>foreign companies</u>, this definition includes any corporation, LLC, or other entity created under the laws of another country that is registered to do business in the U.S.

iii. This definition <u>does not include</u> sole proprietorships, trusts (other than "business trusts"), public companies, tax exempt entities, pooled investment vehicles and the like. But, if such an entity owns an interest in a "reporting company," that ownership may trigger this reporting requirement (see below).

ii. <u>"Beneficial Owners" Definition</u>. A beneficial owner is an individual who (a) directly or indirectly exercises substantial control over the entity, or (b) owns or controls 25% or more of the ownership interests in the entity.

i. <u>Substantial control</u> includes an individual who is serving as a senior officer; who has authority to appoint or remove a senior officer or majority of the board; or who may direct or make substantial decisions over important matters.

ii. <u>25% ownership</u> includes total ownership interest in equity, capital, profit and options; direct and indirect interests; or joint ownership of undivided interests.

iii. For <u>trusts</u>, a beneficial owner includes the grantor/settlor who has the right to revoke the trust or withdraw trust assets; a trustee or person holding authority to dispose of trust assets; or a beneficiary who is (a) the sole permissible recipient of income and principal, or (b) has the right to demand distribution or withdraw substantially all of the trust assets.

iii. Information to Be Disclosed.

    i. For a reporting company, the following information must be disclosed: Legal name, trade name, address of principal place of business and tax identification number.

    ii. For each beneficial owner, the following information must be disclosed: Legal name, date of birth, address, identification number (such as in a passport or driver's license) and an image of the identification document.

iv. Effective Dates. For companies existing as of January 1, 2024, forms must be filed between January 1, 2024 and December 31, 2025; a reporting company created on or after January 1, 2024 must file within 30 days after its creation. The filing requirement is a one-time form with FINCEN, plus an update within 30 days after any changes are made or inaccuracies are found.

v. Penalties. If a reporting company fails to comply with the reporting requirements:

    i. There may be civil fines up to $500 per day (with a $10,000 maximum).

    ii. There may be criminal fines up to $10,000 and imprisonment up to two years.

EXHIBIT B

a. California Income Taxation of Non-Grantor Trusts. California taxes income of an irrevocable, non-grantor trust, wherever situated, if (a) there is California source income, (b) there is a trustee or other fiduciary who is a California resident, or (c) there is a "non-contingent" beneficiary who is a California resident. Unlike many other states which tax based on the residence of a settlor, California ignores this consideration. Thus, if all of the trust's fiduciaries are California residents, then all of the income will be subject to California tax; likewise, if all of the trust's non-contingent beneficiaries are California residents, then all of the income will be taxed by California.

i. Residence. An individual (whether a beneficiary or fiduciary) residing in California is considered a California resident, unless he or she is here on a temporary or transitory purpose. As a rule of thumb, an individual is presumed to be a California resident if he or she spends, in the aggregate, more than 9 months of the tax year in California.

ii. Beneficiary. A beneficiary is vested (non-contingent) if his or her right to receive income from the trust is not subject to any contingency, except perhaps the passage of time (i.e., right to receive the income at a certain age). The beneficiary may also have a vested interest if the accumulated income will be distributed to the beneficiary's estate or if the beneficiary has a general power of appointment over the income at his or her death.

iii. Throwback Tax. Where a non-resident trust was properly refraining from paying California income tax (such as when there is no California source income and no fiduciaries or vested beneficiaries reside in California), California may tax a resident beneficiary when that accumulated income is distributed to him or her. These rules are complex and have several limitations, so please contact us or your accountant for specific application.

iv. Watch Out. A beneficiary who leaves California within 12 months before the date of distribution of accumulated income, only to return to California within 12 months after the distribution, is presumed to be a resident of California throughout the period of distribution. Thus, beneficiaries should carefully assess their connections to California before receiving accumulated distributions.

b. Kaestner Case. In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, the U.S. Supreme Court recently held that North Carolina did not have the power to tax the income of a New York non-grantor trust where there were insufficient ties to North Carolina.

i. Relevant Facts. The pertinent facts of the case are as follows: the trust was created by a New York resident and governed by NY law; the trustee was a Connecticut resident; the trust assets were located in Massachusetts; and the beneficiaries (of a particular subtrust) all moved to North Carolina. In addition, the trust income was from non-North Carolina sources, no distributions were made to any of the beneficiaries, and none of them had any power to demand any distribution.

ii. Court's Decision. The U.S. Supreme Court agreed with the North Carolina courts that the above facts do not provide a sufficient constitutional basis for North Carolina to impose its income tax on the trust's accumulated income. The Court's decision is limited to the specific facts of this case and it did not give any indication as to what facts may alter the result of prohibiting taxation by the state taxing authority.

iii. <u>California Impact</u>. Because of the above limitation, it is unclear what impact, if any, this case may have for California residents. As described above, the California Franchise Tax Board (FTB) would likely wait to tax on the accumulated income of an out-of-state non-grantor trust, at least until distributions are actually made to California resident beneficiaries (assuming there are no other contacts with California and no California source income).

c. <u>ING Trusts</u>. In recent years, one of the planning techniques touted by many advisors to avoid California income taxes is an "Incomplete Non-Grantor Trust" or ("ING" trust for short). Because these ING trusts are typically established in states with no state income taxes, such as Delaware, Nevada and Wyoming, they are at times referred to as DINGs, NINGs and WINGs.

i. <u>Based on PLRs</u>. These ING trusts are based on certain IRS private letter rulings in which grantors would establish irrevocable trusts in which contributions to them were considered to be "incomplete" gifts for federal gift tax purposes. They were incomplete gifts because under the trust, the grantor retained certain powers (though limited to ensure the grantor is not considered to be the trust's taxpayer) to change the eventual distribution of the trust assets.

ii. <u>Gift and Estate Tax Issues</u>. To make distribution decisions, the ING trust appoints a distribution committee comprised in most cases the beneficiaries of the trust, as they are considered to be "adverse parties" (i.e., adverse to each other's interests). This is done so that the grantor may receive distributions without the trust being considered a grantor trust and so that the members of the distribution committee are not considered to have made gifts to the distribution recipients and so that the trust assets are not includible in the committee members' estates for estate tax purposes.

iii. <u>California Income Tax Issue</u>. As indicated above, California will tax an out-of-state non-grantor trust's income if it has a California resident fiduciary. Thus, if the distribution committee of an ING trust is made up of a majority of California residents, it may be subject to California income tax. The ING trusts attempt to avoid this issue by indicating that the distribution committee is acting in a "non-fiduciary" capacity. However, the California Franchise Tax Board makes its own determination of "fiduciary" capacity and may override this non-fiduciary capacity argument.

In addition, due to the California "throwback" tax rules (described above), if the ING trust beneficiary (or grantor) receiving a distribution is then considered to be a California resident, then California may subject the distribution to California income tax.

iv. <u>Pitfalls</u>. In assessing the advisability of creating one of these ING trusts, clients should consider all of the following:

i. Whether distributions out of the ING trusts will subject the income to be taxed in California (or another state with state income tax) based on its other rules (such as the throwback tax, having California source income, etc.).

ii. Despite the argument that the distribution committee may be acting in a "non-fiduciary" capacity, whether a majority of the committee members are residents of California. Please remember that some of the committee members must be beneficiaries of the ING trust to avoid certain gift and estate tax issues.

iii. Be careful about the timing of a significant income tax event, such as capital gains tax upon a sale of an appreciated asset. The California FTB will likely scrutinize more closely a situation where the transfer to an ING trust is closely followed in time by a sale of the asset in an attempt to avoid California income taxes.

EXHIBIT C

a. Income Tax and Basis Planning. Given the doubling of the gift and estate tax exemptions, there are fewer estates that may be subject to estate taxes. Further, the gap between the estate tax rate (40%) and the combined federal and California capital gains tax rate (37.1% if the Medicare surtax is included) has narrowed considerably, such that obtaining a step up in income tax basis may be just as important, if not more, than reducing one's taxable estate (although there could be a step down).

This is especially true for married couples in California holding community property, as the income tax basis in 100% of that property (including the surviving spouse's one-half share) will be stepped up to its fair market value on the death of the first spouse. As a result, if the surviving spouse inherits the deceased spouse's share and soon thereafter sells that property, he or she will incur no estate tax and no capital gains tax. Below is a discussion of how the above facts, along with *portability*, may have changed how we structure estate and tax planning for married couples.

i. Old Law Necessitating Bypass Trust. Before portability was enacted, a bypass (or credit shelter) trust was needed to preserve the first spouse's estate tax exemption. For example, when the estate tax exemption was $1 million, if the deceased spouse did not create a bypass trust, but rather left his or her assets to the surviving spouse outright, the first spouse's estate tax exemption was lost and the surviving spouse was left only with his or her own $1 million exemption. Thus, in that event, the couple needed to create a bypass trust in order to leave their children $2 million, estate-tax free.

Portability changed this, as a surviving spouse can now utilize the deceased spouse's estate tax exemption (if any), even without creating a bypass trust, provided that a federal estate tax return is filed. [We discussed these requirements in our 2017 client letter.]

ii. Disadvantage of Bypass Trust Planning. One disadvantage to creating a bypass trust is that the assets allocated to it do not receive a step up in income tax basis upon the death of the surviving spouse. While the appreciation in value in the bypass trust escapes estate tax, it will be subject to capital gains tax when the assets are sold. This trade-off can make sense to the extent that the surviving spouse's estate, plus the assets in the bypass trust, will exceed the survivor's estate tax exemption. But, if the value of the surviving spouse's estate, plus the assets in the bypass trust, is less than the survivor's estate tax exemption (taking into account the predeceased spouse's "portable" exemption), then the inability to claim a stepped-up basis on the bypass trust assets creates a real disadvantage.

iii. Full Marital Trust Planning. Due to the higher exemptions and the enactment of portability, it may now be preferable for clients to avoid creating a bypass trust upon the death of the first spouse. As we indicated in last year's letter, the IRS now allows an irrevocable marital trust to be created without first having to establish a bypass trust. Thus, through this full marital trust planning (where all of the deceased spouse's assets are held in the marital trust), clients may achieve many of the benefits of the bypass trust (e.g., creditor protection, GST planning, locking in the deceased spouse's wishes as to the ultimate beneficiaries of the trust on first death, and avoiding property tax reassessment), while having the assets of the marital trust stepped up for income tax purposes on the surviving spouse's death.

iv. Planning Going Forward. Clients should review their estate plans to determine the proper planning in this current higher exemption environment. If you are the surviving spouse and there is a bypass trust already in existence, and if the value of your assets, plus the assets in the bypass trust, is less than the estate tax exemption, you may want to explore options to terminate the bypass trust and have those assets included in your estate. This could avoid capital gains taxes when those assets are sold after your death.

v. Swapping Assets in Grantor Trusts. For clients who have created IDGTs in the past and have contributed assets with low income tax basis, you should consider doing a tax-free exchange or sale, using other assets (perhaps cash) with higher basis. That way, your beneficiaries will receive a step up in basis on those assets upon your passing.