CREATION, MANAGEMENT AND TRANSMISSION OF FAMILY WEALTH: THE PERSPECTIVE OF A U.S. TAX LAWYER

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INTRODUCTION

I am 55 years old, born and raised in St. Louis Missouri, U.S.A., a graduate of Harvard College and Michigan Law School. From 1973, just out of law school, until 1975 I worked for the United States Tax Court as a lawyer-advisor (sometimes called a "law clerk") to one of the Senior Judges there. And I have practiced law at Lowenhaupt & Chasnoff in St. Louis since 1975.

I am here to address the creation, management and transmission of family wealth in the United States from the standpoint of a "counselor" to and lawyer for families of wealth.

Lowenhaupt & Chasnoff is a ninety year old law firm, founded by my grandfather, who was the first income tax lawyer in the U.S. and then managed by my father, who was also a tax lawyer, and since his death by me, a tax lawyer as well. We are a small law firm by choice. (We have eight lawyers, which is considered very small for a United States law firm, but when we had eight lawyers in 1945 we were seen as very large for a U.S. law firm.) We have a general practice but each lawyer has a specialty in some field of law. Ours is a "family business" and has provided some wealth to our own family; but it is also a firm which has represented many families of wealth. Some of the clients I work with are the grandchildren and great-grandchildren of clients my grandfather worked with. One of our clients, now eighty-five years old, will refer to my grandfather as "Uncle Abe."

I am an advisor to and teacher at an organization called the Institute for Private Investors, an association of 250 families of wealth under "investment management" – that is, not in an active business – of between 50 million and one billion dollars. In that role, I work with many families as they address some of the issues I will discuss today, that is, as they manage their wealth and consider how best to invest it and how best to use it for their families.

I want to share with you some of the concerns of wealth management and wealth transmission faced by U.S. families. "U.S. families" for these purposes include not only families resident in the U.S. but also families living outside the U.S. who are affected by U.S. taxation, income, estate and gift, because of U.S. citizenship or technical residence or because they have children or grandchildren living in the U.S. And many of the concerns they face are not "national" concerns but human concerns about wealth and its purposes.

OUR ACTIVITIES IN ASIA

Let me digress here a moment and tell you about the activities of Lowenhaupt & Chasnoff, L.L.C. in Asia.

When I began my practice of law in 1973, I would never have described myself as "international" even though I had traveled to many places in the world. I was licensed to practice law in the State of Missouri and I was about to become an attorney-advisor to a judge on the United States Tax Court. And when I joined the law firm in 1975, I would never have described its practice as "international." Yet today I am in Beijing speaking to you as an "international lawyer," and if I look at the history of our firm and my own experience, it seems reasonable that I became what I am.

History of Lowenhaupt & Chasnoff. Our law firm was founded almost 100 years ago by my grandfather, who was the very first income tax lawyer in America. In 1908, there had already been an income tax enacted by Abraham Lincoln's Congress to pay for the Civil War, and that tax was repealed after the war was won. Another income tax had been enacted in 1894 but declared unconstitutional by the United States Supreme Court before any tax could be collected. So my grandfather was bold to believe that there would be an income tax at all; and until 1913, when the Sixteenth Amendment to the United States Constitution was ratified, there was no income tax. So from 1908 until 1913 my grandfather spent five years as a "specialist" with nothing to do. Thereafter he was the "expert." And my father was a tax lawyer; and so am I.

Incidentally, when I started law school I was determined not to be a tax lawyer. But in my third year of law school my tax professor called me into his office and said he could "offer" me three jobs, all in the tax area. Then I realized that my heritage and ancestry were impossible to escape and genetics had taken its toll.

Because we were the first tax firm in the U.S. from 1908 until 1960, about half of our business was purely tax business. Lawyers and accountants would send tax problems to us and expect us to solve them through negotiation with the tax authorities or in court.

The other half of our law practice during this period was more general – serving as lawyers to individuals and businesses, mainly family businesses, primarily in St. Louis, Missouri.

During this period many great American companies evolved. A number of our clients started by serving only local markets. During the era from 1908 to 1960 they grew into large national businesses. They were in businesses like automotive supplies, chemicals, shoe manufacturing, pharmaceutical, food and beverage and retail production and sale.

Our firm worked with these clients as they faced new issues. First they found themselves moving into national markets as the U.S. transportation and communication industries grew. Next they found new challenges of finance and management. Then they found themselves developing wealth and dealing with issues of wealth transmission. Ultimately many of them were sold to others or to the public and the families owning them had great wealth to invest in publicly traded stocks and bonds.

We found that our law practice became "national" in scope as these companies expanded operations throughout the U.S., as the family members moved to live in cities such as New York or Boston or San Francisco, and as our reputation spread for good legal representation. More and more frequently, we were representing businesses and individuals who were not located in St. Louis but were instead located outside of St. Louis. And from time to time, our clients did business outside the U.S. or moved outside the U.S.

<u>Our Asian Practice Begins.</u> In 1995, we received a call from a company which was a Hong Kong-based subsidiary of a Taiwanese family owned company. The caller, who had been given our name by a client performing services in Hong Kong, required help licensing several tradenames in its business of automotive parts. We provided those "intellectual property" services long-distance and had not yet met any of our client's owners or employees. So we had no personal relationship (and honestly I think that our communication with the client suffered because of our never having met).

When I was in Hong Kong in 1996, participating in a program as a tax expert for U.S. families of wealth, I stopped by the office of the company and met the management and one of the owners. The president of the company talked about the company's growth into U.S. markets and some of the problems it was facing, and the more he talked the more his company reminded me of our clients of the 1950's and 1960's. His was the same business, automotive parts "aftermarket," as a family company which had been a client of ours from its founding in 1920 until it was sold to an Italian company in 1980, a client whom we had helped grow from a small manufacturing company into a major national business. The problems of the Hong Kong automotive parts company as it expanded into the U.S. in 1990 were not so different from the problems of the St. Louis company as it expanded throughout the U.S. in 1950.

At that meeting in Hong Kong, after the president talked about his company, he asked me to talk about our law firm. I said that we were ninety years old, that we were family oriented (not only I but several of my partners are second or third generation lawyers), that we were small (about 8 lawyers), and that our focus was on personalized service. I felt experienced in the problems of family businesses and wealth. He observed that there were many companies like his in Hong Kong and that many would like the kind of U.S. legal services we offer.

Now six years later, we are representing several Hong Kong family businesses like his with their U.S. legal questions and several Hong Kong families with issues relating to their personal wealth and its transmission.

So Lowenhaupt & Chasnoff is now "International." The "International" part of our law practice is that we have recognized that we live in a "Global Village." Our law firm has global customers and we are making ourselves available to help them do business in our jurisdiction. We are helping Chinese families create, manage, and transmit wealth tied to the U.S.

Lowenhaupt & Chasnoff attorneys are international lawyers because we recognize that citizens of many nations are now involved in the U.S. business stream and economy and that all of those "foreign" citizens and businesses need legal services rooted in our jurisdiction. The U.S. is a country of laws and lawyers so we are exporting our legal services just as we export our entertainment, ideas and other products.

WHAT KIND OF LAWYER AM I

Let us now return to the questions of wealth management and transmission that I deal with as a lawyer when I advise U.S. families. In other words, let's talk about my practice and expertise.

People often ask me what is my "specialty." I can say that I am a tax lawyer. When I left law school, my first job was as attorney-advisor for a senior judge on the U.S. tax court. Much of what impedes wealth creation and transmission are taxes.

I can also call myself an "estate planner" because we see much of wealth transmission as planning for death and much of planning for death taxes involves making gifts and paying gift taxes.

In assisting in wealth transmission, my colleagues and I must also have familiarity with the laws of real estate, of securities regulation, of business transactions, of employment plans and benefits and of marital rights, to name a few. First, because wealth takes many forms and is involved in many transactions; and second, because any tax law is based on the "substantive law" of the transaction it taxes.

Finally we need some familiarity with international laws and laws of other jurisdictions – at least enough to know when to call a Chinese or French or Brazilian or California lawyer to help us design or defend a transaction.

So my type of law is broad and diversified and cannot easily be categorized. I believe that we play the role of "counselor" as much as the role of lawyer by helping our clients define their goals and objectives even before we help them realize those goals and objectives. I rarely go to court (although our firm has lawyers in court often) and I rarely write a "legal brief." I secure advance rulings on tax matters from the Internal Revenue Service but always to help facilitate a transaction contemplated and rarely to analyze a transaction completed.

My involvement in the field is many layered. I am a lawyer for wealthy families and individuals. I am the Chairman of a subcommittee of the Estate and Gift Tax Committee of the American Bar Association Tax Section, leading studies and working with the U.S. Congress on issues relating to the Generation-Skipping Transfer Tax, a tax hitting primarily families of wealth. And I am an "Advisory Faculty Member" of the Institute for Private Investors (the association for families of wealth), as I mentioned earlier.

I have even recently completed a chapter in a book. The book is called "Wealthy & Wise: Secrets About Money" and my chapter is called: "How to Build a Winning Team of Financial Advisors."

But my wife says that the statutory and court made laws I deal with are not as significant as the laws of human nature. These are the ways humans deal with wealth, mortality and family. They are as universal as any I know. I will show you how they work.

INDIVIDUAL AS OWNER OF PROPERTY

But first let me make one observation about the foundation of wealth management and transmission in the U.S. Wealth management and transmission in the U.S. is predicated on the common law concept of an <u>individual</u> as an "owner" of wealth. The individual has the economic benefit of a piece of property, the control and authority over it and all the other "incidents" and responsibilities of ownership. That is why the passing of ownership at death or by gift is a discernible event on which we can impose an "excise" tax, an estate or gift tax.

Common ownership of property is not through "community ownership" but rather through division of ownership into different interests. For example, division of "ownership" of a corporation is among shareholders, each owning a number of shares of stock. Real estate can be divided between "tenants in common" or "tenants with rights of survivorship" or landlord and tenant or owner and lender. Division of property can also be accomplished by use of trusts or other forms, for example, a "life estate" and a "remainder." In each case an individual "owns" an interest.

Much of "estate planning" requires deconstruction of "ownership" not only by division into interests but also by analysis of "incidents" or benefits of ownership. For example, a father's "ownership" of a company may include: his right to decision-making authority over the business; his right to salary and employment benefits from the business; his right to present economic value of the business; his right to future profits of the business; and the prominence in his community of a business leader. The estate planner must ask whether the father is willing to give away or forego some of those benefits.

In Chinese culture, ownership may not be seen as individual. Like many of our clients in an earlier era, in China a venture may be seen as a "family enterprise" (or even a "collective" enterprise, which is not so different from a "family enterprise") and ownership may not be so individualized. But when I work with a Chinese family, I find the analysis of the elements of "ownership" just as important as when I work with an individual family member in the U.S. That analysis allows us to consider governance structures to meet the laws of "human nature" and wealth transmission techniques to accommodate the taxes imposed by citizenship in the U.S.

WEALTH CREATION

There is an old joke in the U.S. The recipe for rabbit stew begins: "First catch the rabbit." So too the recipe for wealth management and transmission: First build the wealth.

You see wealth being built here in China much as it was built in the first half of the century in the United States by fathers and sons, brothers and sometimes even sisters, daughters or wives. It is done by hard work over many years through manufacturing and distribution of product or sale of product through retail or the development of an idea (what we call in our profession "intellectual property").

"Hard Work" are the two words most often emphasized by the wealth creator or creators, who often spend many hours in the office and traveling away from spouse and children. As the Asian businessman spends many days each week away from home and many evenings in his office or entertaining customers so the American businessman traveled the U.S. on rail and by plane building his company, whether automotive parts or shoes or pharmaceuticals. He found himself with ready labor and expanding markets throughout a vast land. He grew often on the expansion in the automotive or retail market much as the Shanghainese or Hong Kongese or Taiwanese has grown on the expanding U.S. economy over the past years. Many of the details of corporate finance were irrelevant as he built his business in good markets where margins were broad enough to provide capital.

As our businessman built his business, his life was his work and his work was his life. And his family often grew without him. His objective was to support his family and build wealth for his family but he often forewent the relations with his family which his workers might call family life. He was a model of hard work and dedication to the proposition that creation of wealth is wealth's highest good and its own reward.

Of course wealth can also be built in arenas other than creating and manufacturing and selling goods. Some built wealth in real estate. Some built wealth in capital management in the stock markets. (Few build great wealth in the professional service industries – accounting, medicine and law.)

WEALTH MANAGEMENT

Those of our clients who have built wealth and maintain it in one company or business have never really had to address the question of wealth management from the standpoint of diversification of investment. Although they have the problems of taxation we will discuss below, they do not have to develop portfolios of investments as do those who can realize their wealth during their lifetimes. Instead their questions of wealth management are really questions of running the company well, doing business soundly and prudently.

But any owner of a business in considering wealth management must at some time consider whether the prudent wealth management is in realizing some portion or all of the value of the business by its sale or liquidation in whole or in part. The wealth creator or the wealth inheritor must determine how best to realize his and his family's goals.

He can show the world how successful he has been by selling the company he has built. Sometimes the sale is to younger family members; sometimes the sale is to employees; more frequently the sale is to outsiders, competitors, investment bankers and sometimes to large business conglomerates.

He can also decide that the family's goals should include giving employment and satisfaction to his children or grandchildren by maintaining the family business even if its profits might be greater if sold. We have had very wise clients who have made this decision, but there are not nearly as many today in the United States as there were many years ago or there are now in Japan. And in fact it is very rare to find an active business which has been family owned and operated for four generations. (I choose four because ours is only at three). The difficulty of maintaining a family business for many generations is partly due to the concepts of equality we will discuss later.

In the United States today, long-term capital gains rates are between 8% and 20% (plus state capital gains rates), which is historically a very low rate. Yet frequently the realization of wealth is delayed to postpone those taxes or one of several transactions is utilized to postpone those taxes.

Once the family business is sold, the family has cash or capital stock in the purchaser, often a publically traded company which can be bought and sold on the New York Stock Exchange. That is when the wealth creator or inheritor must address issues of investment of the proceeds.

PORTFOLIO MANAGEMENT

"Portfolio management" is the management of investments in an "investment portfolio." Investments in this context are generally seen as companies in which the investor is not active from a business standpoint. The investments generally consist of the following: stocks, bonds, commodities (such as metals, agricultural products and currencies) and interests in partnerships, limited liability companies and other entities. The challenge for the investor is to decide how to structure the portfolio and what to invest in.

The structuring of an "investment portfolio" starts with a determination of what percentage of the portfolio should be in various classes of assets. A typical portfolio in the U.S. might have 60% of its assets in stocks and 30% in bonds and 10% in cash, held to buy more of stocks or bonds. Of the stocks, most will be large U.S. companies traded on the New York Stock Exchange or NASDAQ (so called "large caps") but 10% of the overall portfolio may be in smaller U.S. companies (so called "small caps") and 10% may be in "international stocks," that is, stocks traded on exchanges outside the U.S.

If the investor is an individual investing his own money, there are no governing laws to direct how he invest. But if he is a trustee investing trust funds, most U.S. laws require him to invest as a "Prudent Investor." This so-called "Prudent Investor Rule" has been designed to reflect what a reasonable person should do with his investments. The rule sets out good sound investment principles. It has several elements I will mention here because they are seen as reasonable for any investor whether or not required by law. In fact, in Hong Kong I sometimes meet with clients to discuss how to implement procedures and governance in part to adopt those rules where no law required it.

First is the requirement that the investor should determine his goals and needs. How much income does he need (presumably to live on) and how much appreciation does he desire? How concerned is he about inflation and how much risk is he willing to take with respect to short term appreciation and depreciation?

Second is the determination of "asset allocation" which is to be set with the goals and needs in mind. Studies have shown that investment performance is more dependent on the decision of what **types** of investments to make than on what particular stocks or bonds are purchased. Generally, bonds are perceived as providing income and security of absolute value while stocks are perceived as providing capital appreciation and growth and protection against monetary inflation.

Third is the selection of the specific stocks and bonds (or other assets) which must be made with "diversification" in mind. Diversification requires within each class of asset many issues in many industries on the proposition that the investor should not have "too many eggs in one basket" – in other words, if one company or industry performs poorly the entire portfolio must not suffer.

These rules are merely general rules and the wise private investor may not follow them even though the U.S. lawyer is obligated to set them out. They become even more difficult to follow when a family has substantial wealth in an active business and is considering the investment of its nonbusiness wealth.

I know of two families, one U.S. and one Chinese, both with core businesses. The U.S. family's core business is retail clothing shops with suppliers throughout Asia. The Chinese family's core business is coordinating manufacturing in Asia for U.S. retailers (including the company of the U.S. family). The U.S. family has hired an expert to invest its "outside assets" in Asian companies; the Chinese family has hired an expert to invest its "outside assets" in U.S. companies. But the similarities end there. The U.S. family wants only companies that are unrelated to clothing and retailing because they want to "diversify" so that if their industry of selling clothing does badly their Asian wealth is unaffected. So the U.S. family is investing in Chinese real estate companies, utilities, electronics and the like. The Chinese family members on the other hand believe they understand their industry and should buy U.S. companies they see succeeding in selling items the Chinese family can help them manufacture, companies to which they can "add value" through their own expertise.

Another observation I can make watching families over many generations is that a person often feels comfortable with the investments of his father and grandfather. We have some clients whose family wealth has been in real estate for many generations who feel comfortable owning real estate and consider stocks "risky" or gambling; but we have others whose family wealth has always been in common stocks (whether on the New York Stock Exchange or otherwise traded in the stock markets) who will have ninety percent of its wealth in the U.S. stock market (on "Wall Street" so to speak) and feel no concern about market risk. Similar statements can be made about families whose wealth has always been in a commodity or in farming or in any other investment. Comfort levels and investment success have long traditions of investment philosophy which are passed from generation to generation.

UNITED STATES TAX LAW

Perhaps the greatest impediment to building and preserving wealth in any country is foolishness. We say that "families go from shirt-sleeve to shirt-sleeve in three generations" and that proverb which I will discuss again later means that grandchildren lose the wealth grandfather created. That is not always true but is frequently true.

In the United States (and in many other countries) the next greatest impediment to building and preserving wealth is taxes. In the U.S. income tax rates have been as high as 90% and today the top rate is 39% plus state and local income taxes which can add another 15% in some areas of the U.S. And in the United States the expressed estate tax rate once was higher than 90% and is today 50% on estates over $2.5 million; and death taxes on gifts to grandchildren can approach 75%. Imagine that a man with $16 million at his death would be able to pass only $4 million of it to his grandchildren as $12 million went to the government in taxes! More about him later.

Relevant taxes are broken into two general areas: income taxes and "transfer" taxes. "Transfer taxes" are estate, gift, and generation-skipping transfer taxes.

As I mentioned earlier, the first U.S. income tax was imposed by the North to pay for the Civil War in the middle of the nineteenth century and repealed after the war was won. The second was imposed in 1894 but declared unconstitutional by the United States Supreme Court in Pollock v. Farmers' Loan and Trust before any tax was collected. In 1908 my grandfather decided that the income tax would someday be enacted and became an "income tax lawyer" and in 1913, the Congress and States adopted the Sixteenth Amendment to the United States Constitution which authorized a tax on income "from whatever source derived."

The income tax was imposed on "income" and it was believed that inheritances and gifts could not be "income" so the tax did not hit "transferred" as opposed to "earned" wealth. In 1916, the U.S. Congress concluded that a person could become rich by inheriting wealth as well as earning it and enacted a tax on the estate of a U.S. resident instead of taxing inheritances as income (although the rates and scheme were intended to complement the income tax).

In 1924, Congress decided that a person should not be able to avoid the estate tax by making gifts before death and enacted the Gift Tax, which taxed any gift made almost as if it had passed through the estate of the person making the gift. That tax was repealed from 1925 through 1932 but has been in effect ever since 1932.

With these three taxes, income, estate and gift, the United States had what was once called "The Iron Ring of Taxation." Wealth was taxed as earned, as given during life, and as bequeathed at death. And the "Iron Ring of Taxation" has been in effect throughout the remarkable growth of wealth in the United States over the last eighty years. The income tax raises significant revenue; the estate and gift taxes do not but instead are seen as serving a social purpose of dispersing wealth and ensuring return to "shirt sleeves" within three generations. One wonders whether that "Iron Ring" has really had the result of impeding wealth creation and transmission.

The last "transfer" tax was enacted in 1976 and repealed and reenacted differently in 1986. This is the "Generation-Skipping Transfer Tax," which taxes gifts to grandchildren and great-grandchildren (and beyond). It hits only the "wealthy" and it is the subject of the American Bar Association Tax Section subcommittee of which I am Chairman.

The income tax taxes only income and capital only to the extent gain is realized. So in many respects it is a benign tax unlike a net worth tax (as, for example, France has). The questions that arise under the income tax are: what is income; when is it recognized; and what is the rate of tax. Within those three questions lie many complications but it can be said that the tax itself can be postponed and reduced in ways that allow U.S. taxpayers legitimately to consider it not a great impediment to growth of capital. In fact, capital wealth can grow with no tax so long as gain is not realized to be taxed as a "capital gain."

"Capital gains" are taxed generally as income but at a lower rate of tax. As I mentioned earlier 20% is now the highest rate of tax. A capital gain is the gain on the sale of a "capital asset," such as a share of stock, a piece of investment real estate or a business; and a "capital loss" is a loss deductible subject to limitations on the sale of a capital asset. The capital gain is computed by subtracting from the "amount realized" (generally the sales price) the "cost basis" (generally the purchase price) of the property and allowing further reductions for commissions and other costs.

Since 1914, there have been many different treatments of capital gains and many different rates, but capital gains have almost always been taxed at rates lower than ordinary income. This is why we always talk about "income tax rates" and "capital gains tax rates." The reasons given for the different tax treatment are several. First it is believed that these gains "accrue" over many years so that it would be unfair to tax the full amount in the one year when the property is sold. Second, it is sometimes said that the amount property is sold for merely reflects future income. For example, if I sell a piece of real estate for $100, the purchaser is paying what he believes he will receive in rent over the years (valued at present values). Third, it is sometimes said that a tax on capital gains discourages investment and reducing that tax will encourage investment. Many countries do not tax capital gains at all for that reason.

My grandfather was involved in many debates on whether and how to tax capital gains in the early years of the income tax. Those debates continue today. Yet it must be emphasized that no tax is due until an "amount" is "realized" and "recognized." It is realized when the property is sold or exchanged. It is recognized often but not always; for example, sometimes when similar property is exchanged, gain is "realized" but not "recognized."

The taxes that impede the transmission of wealth are the "transfer taxes." These taxes have expressed rates this year of 50% (or in the case of the Generation-Skipping Transfer Tax on transfers to grandchildren up to a total of almost 75%) and there have been periods in U.S. history where the estate tax rate has been higher than 90%. The transfer taxes are imposed on all assets, that is capital as well as income so that as a tax it looks quite burdensome.

In fact, when Chinese clients come to us to talk of renouncing U.S. tax status (a very complicated prospect under present law) it is almost always expressed as on account of estate taxes. The client has built great wealth and does not want it lost in taxes as it passes to his children or grandchildren.

Yet U.S. families of wealth know that the transfer taxes are not as burdensome as they look. In fact, one scholarly journal a number of years ago called those taxes "voluntary taxes" because they can be so easily minimized legally with planning and over time. This pursuit of minimizing transfer taxes is often called "Estate Planning" and in the U.S. there are industries of lawyers, accountants, life insurance professionals and financial advisors dedicated to the service of reducing estate and gift taxes. I am in that industry.

THE ESTATE AND GIFT TAXES

A brief outline of the Estate Tax will be helpful here. First, let me explain that the U.S. estate tax is now being "phased out" so that in 2010 there will be no estate tax. In that year, there will still be a gift tax and there will be a so-called "Carry-over Basis" rule I will describe later.

But present law provides that in 2011 the estate tax returns at rates as high as 55%! There will be changes in the law so I will discuss the estate, gift and generation-skipping tax later as they exist today, in 2002.

We start with a decedent's "Gross Estate," which is determined by reference to his worldwide assets. Unlike countries which tax only assets located in the country, the U.S. taxes assets wherever they are held.

We must value every asset in the estate and here is the first area of estate planning and discussion. If the asset is 100 shares of General Electric Company which is traded on the New York Stock Exchange, valuation is easy. But suppose instead the asset is a family owned business or investment company, where under the law the value is "what a willing purchaser will pay a willing seller" when we have neither a purchaser nor a seller. Valuation becomes more complicated and any good estate planner will look for ways to reduce the "value" of an asset for these purposes.

For example, the ownership of 49% of a company will not allow control of the company and should result in valuation well below 49% of the value of the assets in the company. Should a company be valued by reference to the assets held in the company or the income paid on as dividends to the company's owners? Should the valuation take payable taxes into account? U.S. courts are full of tax cases on these issues. Valuation is a substantial area of tax law.

Certain transfers made during life are disregarded in deciding what is in the decedent's Gross Estate and amounts transferred are "brought back into his estate" for tax purposes. For example, if the decedent transferred an asset to his son but had an agreement that his son would return the asset at decedent's request, that transfer is not treated as a gift when made; instead the asset is included in decedent's gross estate on his death as if he had never made the transfer. Or if the decedent transferred an asset into a trust but keeps the right to the income from the trust or the benefit of the trust during his lifetime, the trust is included in his Gross Estate. If the decedent has the power to remove assets at will from a trust, the trust is included in his estate. Similarly, if the decedent had the power to decide during his lifetime where trust assets will go during his lifetime or at his death, the trust assets are "brought back" into his estate. Or if the decedent has rights of ownership in an insurance policy, the benefits paid at death (even to another) are includible in his estate.

Once the Gross Estate is determined certain deductions are allowed to compute the "Taxable Estate." Debts and losses and expenses of administration are deductions. So are any gifts to charity. And so are gifts, whether outright or in certain types of trust to a spouse, and this deduction is called the "Marital Deduction." Here worth observing is the principle that if the spouse is not a U.S. citizen, the deduction for gifts to him or her is severely limited, generally to $110,000 annually in 2002 ($120,000 in 2003 as indexed for inflation), and deduction for bequests at death is limited to amounts passing under a special trust called a Qualified Domestic Trust. There are very complicated formulae used to set the amount to qualify for "Marital Deduction."

Once a Taxable Estate is determined, prior taxable gifts are added to compute a "Tentative Tax." But even after the tax is computed, certain credits are allowed, the most significant of which is the "applicable credit" (sometimes called the "unified credit"), which ensures that the first $1,000,000 (an amount that is scheduled to increase to $3.5 million between now and 2010) is not taxed. This means that a U.S. husband and wife can have up to $2,000,000 (in 2002) together before any estate tax is imposed. But significantly today the applicable credit for a non U.S. person shelters only $60,000 in assets as compared to the $1,000,000 for a U.S. person.

The gift tax is intended to parallel and to coordinate with the estate tax. So when I say that a person can have a taxable estate up to $1,000,000 before an estate tax is due, I mean that he can have a total of taxable estate and taxable gifts of up to $1,000,000. But unlike the increase for estate tax purposes that $1,000,000 for gift tax is <u>not</u> scheduled to increase between now and 2010.

Generally, the gift tax is actually lower than the estate tax. This is because the gift tax is imposed on the value of the property received (that is there is no tax on the tax, or it is "tax exclusive") while the estate tax is imposed on the value of everything the decedent owned (that is the tax must be paid on the tax and it is "tax inclusive").

There are significant deductions and exemptions to the gift tax. Some are parallel to those of the estate tax, like the deduction of amounts passing to a spouse or to charity. Others are unique to the gift tax, of which the most significant are gifts of up to $11,000 per year to each donee and payment of tuition or medical expenses for a person. These amounts can go to or for the benefit of the donee free of all gift tax.

Significant differences in the gift tax are that the $1,000,000 exempt amount will not increase between now and 2010 and the gift tax will not disappear in 2010 (both as the estate tax is now written). But another significant difference between the Gift and Estate Taxes is that property passing through an estate has a "stepped-up cost basis" for purposes of the capital gains when the property is sold whereas the property received by gift has a "carry-over cost basis" increased only by gift tax paid. This can be seen by example. I own shares of General Electric Company for which I paid $10 per share. If I sell those shares for $25, my capital gain is $15 per share. If I give those shares to my children without gift tax, when they sell the shares, their gain

is also $15 per share. But if I die owning those shares when they are worth $25 per share and my children inherit and sell the shares at $25, their cost is "stepped-up" to $25 per share so no gain is realized when they sell the shares.

Our present law provides that in 2010, where there is no estate tax (but there is a gift tax), cost basis will "carry-over" at death just as it does for gift. But under present law, in 2011, step-up will return with the estate tax.

The final transfer tax is the Generation-Skipping Transfer Tax, which is another tax imposed on any amounts passing to grandchildren or more remote descendants. The details are complicated but again gifts of $11,000 and payment of tuition and medical expenses escape that tax and so does the first $1,100,000 (in 2002) of gifts (the Generation-Skipping Tax Exemption or "GST Exemption"). Incidentally, that $1,100,000 ($1,120,000 in 2003 as indexed for inflation) is scheduled to increase with the exempt amount beginning in 2004.

ESTATE PLANNING AND TRUSTS

To illustrate the effectiveness of estate planning, let us go back to our man with $16 million at his death who can pass $4 million of it to grandchildren and must pay the $12 million to the government in taxes. Actually in the U.S. those rates of 50% and 75% I referred to are rarely paid on the total family wealth. Instead actual taxes are often only 10% of the family wealth of very wealthy families. This is because those families "plan" their estates by making gifts in trust or otherwise during their lifetimes, that is by "estate planning." So with "estate planning" our man with $16 million of family assets might actually die paying only $1.6 million in taxes.

When most lawyers talk about estate planning law they are thinking of planning an estate to reduce transfer taxes. That planning requires divisions of property, gifts, utilization of charitable gifts and utilization of the Marital Deduction. The estate planner uses trusts for many of the gifts and for the provision of bequests in part to protect the assets from young beneficiaries and in part to provide opportunities for tax savings.

I am not certain how familiar you are with the common law concept of trusts, which evolved in England in the 16th century. Civil law does not recognize the trust so it is entirely a "creature" of the common law and is well recognized in the United States, Canada, England, Hong Kong or Australia but not in France, Italy or South America. China now has a new law of trusts but I do not know all its details. (I do know that Professor Frances Foster of the Washington University Law School (now visiting at the University of Michigan) is studying this law extensively and will be writing about it. She has shared some of her research with me.)

A trust is generally a division of property into various interests, which can be accomplished without a trust by various means including future interests, corporation structure, partnership structure and the like. But in a trust, one person or persons, the trustee or trustees, have legal ownership of property while others, the beneficiaries, who can be alive or not born yet,

have beneficial ownership. The trust is generally established by yet a third person, the Settlor or Grantor, and almost always by a written agreement or "indenture."

For example, I can give property to Bill Trustee to hold in trust for my son for life and during my son's life to pay him income and principal of the trust as Bill Trustee thinks he needs (or to pay him all the income of the trust and to pay him principal as Bill Trustee thinks he needs). I can say that on my son's death, that trust should go to those of my descendants as my son directs in his Will. If my son does not direct I can provide that the trust continues for the life of my grandson and finally on his death goes to his children and grandchildren.

The trust can be completely flexible. Some jurisdictions limit its duration. Beneficiaries can be anyone; trustees can be individuals or certain corporations. Provision can be made as to what assets shall be held and how they should be managed.

Trusts are used in estate planning to divide assets among various beneficiaries. For example, when we say that a husband and wife can have $2,000,000 between them before there is a tax, we really mean that each can have $1,000,000, and if a husband has more than $1,000,000 we will use a trust to get as much as $1,000,000 to his wife. Trusts can be used to provide income to charity for a term of years and remainder to children in such a way that gift taxes are reduced by the value of the charity's interest. Actuarial tables and valuation are used to reduce the values of the private "gifts" in trust and the result is reduction in estate and gift tax.

So using trusts and gifts and wills and other vehicles estate planning tries to take full advantage of the many opportunities offered. Clients are encouraged to make the $11,000 gifts and to pay tuition and medical expenses. They are encouraged to ensure that each spouse has enough assets individually owned so that joint taxes are reduced. They are often encouraged to make big gifts so that appreciation after the gift will be out of their estates and the gift tax paid will be lower than the estate tax. And they are encouraged to use gifts to charity and others to reduce taxes.

ISSUES OF SUBSTANCE IN WEALTH TRANSMISSION AND MANAGEMENT

If my job were merely to save taxes for clients, I should be very busy and very effective. But counseling requires much more. And the substantial issues of wealth transmission and management are broad and deep and universal for they are the issues of human nature. We should look at some of them.

What is Wealth For? That is the question that needs to be asked over and over. Until that question is answered there is little a counselor can advise. And there are as many answers as there are clients.

Start with the proposition that some wealth is necessary to provide food, clothing, shelter, medical care and other necessities. Any family will want wealth as well to provide for education for children (and grandchildren). Then a certain amount of wealth is nice for minor luxuries,

whether travel, entertainment, liquor or a higher degree of comfort in necessities. Then there is some amount of wealth (whether $1,000,000 or $100,000,000 I do not know) which is kept for "just in case" – that is in "just in case" the stock market crashes, "just in case" I get very sick, "just in case" I live too long and so forth.

For some, the wealth of the active business cannot be removed because the business uses its wealth to grow and prosper. For some, like investment bankers, wealth is inventory to be used in business to purchase companies and to commence entrepreneurial ventures.

Beyond those clear uses of wealth lies the area where opinions differ as to what wealth is for.

My father always said that "Wealth in life is like salt on a potato. A little is necessary but too much is terrible." What did he mean? He meant that children of wealth often grow up without the work ethic of the creator of the wealth. And for many creators, that is seen as quite evil. Warren Buffet, the multi-billionaire U.S. businessman, has announced that he will not give any of his children more than $1,000,000 (although the number changes) because great wealth will "spoil" them. Many of our clients in the U.S. are now taking a similar attitude.

Others see their wealth as allowing their children to grow in ways they did not. I have seen very wealthy parents raise children to be great teachers, diplomats, scientists, philosophers and similar professionals who need not concern themselves with the creation of wealth. Those parents must start early to raise their children to recognize that the creation of wealth is not its only value. If they fail in that education, the children can turn out desperate to create more wealth and incapable of replicating their parent's successes.

Wealth can be seen as allowing the betterment of the community. Raising children to be diplomats or teachers is part of that. So is the use of wealth for charitable purposes. Wise parents of wealth see charity as playing an important role in showing children and friends that wealth has value beyond mere creation. And it is not surprising that Bill Gates of Microsoft has begun philanthropy on a massive scale, giving away billions of dollars to schools and worthy institutions.

In every culture where wealth is built and owned by individuals, whether or not the culture has an estate or gift tax, philanthropy will be an important piece of wealth transmission. I am seeing this in Hong Kong and Taipei today; it has been prevalent in Europe for many years. I read that China is building its law of not-for-profit institutions. And it is not surprising that the U.S. with the world's predominance of billionaires is also leading the world in amounts given by citizens to charity. Charity and involvement and support of it are the ways to teach values to family.

"Strategic Philanthropy" in the U.S. are terms used to describe the ways families can use charity to build family harmony and give family purpose to families of great wealth. Rockefeller

Foundation, Ford Foundation, McArthur Foundation, Turner Foundation, Gates Foundation: these are the names of foundations started by families to pursue charitable goals. These Foundations help a family save taxes but more importantly they help a family make an imprint for good on their world.

Shortly after September 11, 2001, I was leading a program for wealthy families. I asked how the terrorist attacks on New York and Washington had changed their attitudes towards wealth. The older ones all said that they would now give more to charity. They saw world needs and family needs greater than before.

Ultimately every person's wealth is either spent by him or her during his or her lifetime or passes to his or her descendants (or other private beneficiaries), to charity or to the government in taxes. When my client can tell me how much wealth he or his family needs and what wealth is otherwise for, I can help him divide his wealth among those parties. Rarely does he want it to go to the U.S. government in taxes!

"Shirtsleeves to Shirtsleeves." To illustrate the universality of human nature, I can quote a well-known U.S. expression often mentioned in helping families plan their wealth and its transmission: "Shirtsleeves to shirtsleeves in three generations." This proverb was often quoted by my father and his father before him when they discussed the problems our clients had in preserving wealth. It is intended to express a classic progression from the creator of wealth, who wearing shirtsleeves (rather than a business suit) works hard and lives frugally, to his children, who study at the university, wear fashionable clothes and live in good style, to his grandchildren, who grow up in wealth and do not work but spend all of the money so that the next generation again wears "shirtsleeves." In other words, family wealth starts in creativity, then has a period of status quo, and then decays. But this is not merely the U.S. progression. I understand that in China people talk of "rice paddy to rice paddy in three generations"; in Japan there is a similar expression; and in Ireland it is "clogs to clogs in three generations" as people move from potato rather than rice fields. So here we have here a fundamental truth of wealth in all cultures. It exists regardless of the codified national laws because it is a "human law."

Equality. Let me show you how so called "technical issues" in my law really reflect human concerns that transcend the law. The concept of equality is one I address first with clients "technically" and then explore in very human rather than legalistic terms.

Most of our clients come to me saying they want their estates divided "equally" among their children. But what does that mean? England for many years had a system of primogeniture: The eldest son inherited all of the family real estate (which was usually all of the family wealth). His younger brothers and sisters were forced to fend for themselves, and many went to the Americas, Australia, Hong Kong and India to find it. So it may be that primogeniture encouraged British colonization. But it also clearly allowed wealth to stay in the hands of family managers.

In the U.S. the model is different. The founder of a company will more commonly want to leave everything "equally." That often means that all children get an equal share of the company even if only one son is working in the company; and the result is often ownership by family members who do not work and want merely profits out of the company. Of course this leads to tensions between dividends and salaries, retention of earnings and distribution of earnings and other disagreements which often result in the sale of the business.

I have watched many businesses destroyed by family arguing and fighting. There are some businesses (but very few) where third and fourth generation members all work harmoniously together to run a business. Usually the businesses are not robust enough to support so many relatives; often the second generation start bickering. Their children vie for management positions and control and money.

The wise father develops ways to deal with the dangers of "dollar for dollar equality." He might leave the business to one child and all of his other assets to the others. He might provide for the active child to have voting control of the business. He might start separate businesses, one for each child. Or he might sell the business before his death and divide the cash evenly between his children (but may hurt the son who has built a career in the business sold).

"Dollar for dollar equality" means that if one child receives $100, each child receives $100. This is mathematically clear but often quite unsophisticated. Another approach is to "meet needs equally" usually using trusts. That is, if my daughter is ill or has no other resources I leave or give her more than I give my son who has built his own wealth or married a wealthy woman. Particularly when wealth is not large, this equality based on need is a more reasonable approach to wealth division.

<u>*"Per Capita"* and *"Per Stirpes."*</u> Do you know the words "*per capita*" and "*per stirpes*"? They are used in drafting wills and trusts to describe how property should be divided among grandchildren and more remote generations. *Per capita* means "by the head," that each person (usually a grandchild) receives an equal share so that if I have two children and five grandchildren, four by one child and one by another, each grandchild receives one-fifth of the total gift. *Per stirpes* means "through the roots" so that one grandchild gets one-half and four each receive one-eighth (that is their parent's half). I find that when grandchildren are unborn or unknown, people think "*per stirpes*" as they know only their children and not their grandchildren. When grandchildren are known, people think *per capita* so as not to penalize the child of the child who decides to have four children.

Should wealth pass primarily to children and should their children merely take as substitutes? Or should wealth pass among individuals? These are fundamental issues which are raised when discussing those words "*per capita"* and *"per stirpes*." The issues are human; the words are legal.

Age of Responsibility. At what age should a child inherit outright and when should the trust end? I have heard as many answers to that question as we have clients.

There are those who say the younger the better, 21 or 25, so the child can accustom himself or herself to wealth and learn to live with it; and if he or she loses the wealth, he or she is young enough to pick up his or her life and start again. There are those who say the wealth should stay in trust for the life of the child, always to protect it against his or her foolishness. And in between are ages from 30 to 65 and arrangements where the property is distributed from trust in portions; for example, 1/3 at 25, another third at 30 and the balance at 35.

And often the older the client the older the age at which he believes his or her child can manage wealth well. My father worked with steel foundry owners who were brothers ages 85 and 90. When my father inquired about the son of the 90 year old, a man then 65 and who had worked for the business for 40 years, the 85 year old replied, "Give him a few years and he will be a pretty good foundryman."

The retention of wealth in trust can go beyond the child's generation and into the generations of grandchildren and great-grandchildren and beyond. The old common law of England put time limits on the duration of trusts by means of the Rule Against Perpetuities, but many jurisdictions now allow unlimited duration trusts. Indeed the creator of wealth may see perpetual trusts as the way to avoid the return to "shirt sleeves." But ultimately he must ask how long can his "dead hand" control the family from the grave? That too is a question each client must ask.

What wealth is for, how long it can be maintained, how to create "equity" in division and how to "protect" future generations, these are fundamental human issues of wealth and are not statutory or jurisdictional. I have studied the laws and the cases and learn from them what my culture believes are reasonable human expectations and goals. I can then use that learning to help clients of my culture and others analyze their situations and set goals and objectives.

LAWS OF HUMAN NATURE AND MY PRACTICE

We talk about international business. Business, whether international or not, is about wealth, and wealth is the subject of my practice. And many of those human issues relating to wealth are international and without cultural attributes. Wealth management is never far from international business and human nature's law is never far from wealth.

Often when I am working with a Hong Kong client who owns a growing manufacturing business we will expand our discussion from the activities and issues of the business to the personal questions and issues he sees relating to his growing wealth. I frequently hear the Hong Kong client say "You will not understand this concern because it is cultural" followed by a concern about privacy, family values or other matters which are identical to concerns voiced to me confidentially by our U.S. clients. In Hong Kong I asked a 30 year old man starting his

successful business and his family whether he wanted to know what he would be saying to me when he was 70. "How do you know, he asked?" I responded, "Because I knew you when you were 70 years old living in St. Louis, Missouri in 1975." He is creating a business and trying to raise a family just as our clients of the 1930s did and he is facing the same human issues.

These are issues of how to raise children with motivation, how to use wealth for satisfaction and happiness, how to encourage good human values and love for fellow man, how to ensure that your children are valued for what they are, and how to leave the world better than you found it. As a U.S. lawyer I learn how to help my clients deal with those issues. I can also help citizens of other countries deal with the same issues.

These issues arise when the lawyer talks to the client – counsels him or her – about business affairs, about a Will or estate plan. This is the opportunity to help the client set goals and ideals as he considers a reasonable arrangement for his passing of wealth after and before his death.

I write many wills and trusts. The Last Will and Testament and the Trust are important documents partly because they allow orderly transmission of wealth at death with minimum family argument and partly because they require the "Testator," the person writing the will, or the Settlor to consider his life, his mortality, his values and his family. He discusses these matters with his lawyer, his "counselor," who is something like a priest here listening to the innermost thoughts of his parishioner. How intimate and satisfying that relationship can be!

The Law of Human Nature is the universal law and the highest law in any society that allows for individual wealth creation and transmission. Tax laws and trust laws and property laws become relatively inconsequential next to the international laws of human nature. I am with families in Hong Kong who are addressing issues identical to those addressed by families in St. Louis, Missouri even without tax considerations. What is wealth for; how to create family harmony; how to motivate children; how to use wealth to make satisfaction and happiness; how to ensure that what is needed will be there; how to help one's community. As lawyers, we do not have form solutions. Helping with wealth management and transmission allows us to counsel our clients as they seek answers to these fundamental human questions.

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