Harris myCFO is dedicated to managing the complex issues that face individuals and families of significant wealth by delivering the guidance and services of a comprehensive family office, along with the freedom to use your own trusted advisors and other best-in-class service providers.

Unlike other advisory firms, Harris myCFO offers expertise in all areas of wealth services: Income Tax Planning & Compliance, Investment Advisory, Estate & Trust Planning, Risk Management & Insurance, Philanthropy, and Expense Management & Financial Reporting.

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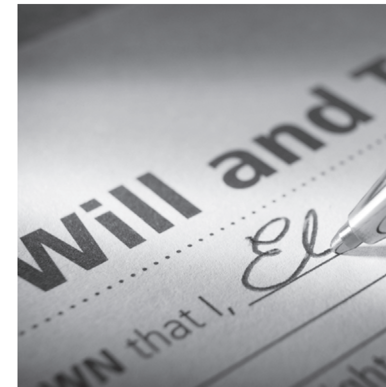

How Derivatives Enhance Your Estate Plan

You may be familiar with the use of financial derivatives to hedge against various market risks. Today, however, derivatives are being increasingly used in estate planning. This article looks at how derivatives can protect the future value of significant assets and help investors efficiently transfer wealth.

What are derivatives?

A derivative is a financial instrument that mirrors the value of an underlying asset. Rather than trade in the asset itself, investors enter into a contract to exchange funds, assets or some other value at a future point in time, based on the value of the underlying asset.

Derivatives can be based on many different types of assets, including stocks, bonds, commodities, interest rates, exchange rates, or indices (such as stock market indices). Typically, they are used to protect investors from dramatic fluctuations in the value of an asset within a portfolio. For example, derivatives have been used to hedge against fluctuations in interest rates, foreign currency exchange rates, and the volatility in commodity markets such as natural gas rates for businesses that are sensitive to energy prices.

Today, derivatives are being used for various estate planning applications. They are particularly useful when an investor holds an asset that has appreciated significantly over time, and when selling the asset outright would trigger negative tax consequences. By using derivatives, one can potentially delay sale of an asset, while freeing up funds to reinvest elsewhere and diversify. Two derivatives frequently used to achieve these goals are collars and prepaid variable forward contracts.

Collars

A collar is an options strategy that involves purchasing a **put option** (see Glossary of Terms) and the simultaneous sale of a **call option** on the same underlying asset. The collar uses the proceeds from the sale of the call to finance the purchase of the put. So it can potentially be a zero cost transaction.

A collar creates a "band" of values within which the value of a certain security will be worth to the investor, at a given point of time in the future. For example, if a stock is currently trading at $100, that band could range from $90 to $120. It creates a floor and a ceiling value for the security.

Investors who hold large positions in an underlying stock and would like to liquidate their holdings at some point in the future often use this type of derivative. A collar enables you to lock in a minimum and a maximum sale price, thus insuring against a big drop in the price of a stock. After implementing a collar, you know the exact highest and lowest dollar amount you can potentially receive when you sell your underlying stock. However, this insurance comes with a price, because the upside potential of the stock is capped as well.

Variable Prepaid Forward Contracts

Variable prepaid forward contracts are another highly flexible derivative used for monetizing a concentrated asset. In this instance, an investor agrees to deliver some or all of the underlying shares at a future date, in exchange for an up-front advance of cash today. Using a variable prepaid forward contract, you can use this cash advance to diversify your overall investment portfolio.

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At maturity, if the share price of the underlying asset has fallen, you may be required to deliver 100 percent of the underlying shares to repay the contract. If the share price has appreciated, you may be able to deliver only that percentage of shares necessary to repay the contract amount. In some cases, an investor may have the right to "cash settle" the trade and retain the underlying shares.

The big question then, in choosing between a collar or a variable prepaid forward contact, is whether or not you wish to take the proceeds from your derivative transaction and re-invest them to further diversify your portfolio.

You may be content to simply lock in the future value with a collar. To diversify, you would need to use other assets, or to take out a loan against the value of the collar. With a variable prepaid forward contract, however, the loan element is built right in. So you can potentially take up to 75% or 80% of the value of the contract and re-invest it elsewhere, immediately.

You can use collars and variable prepaid forward contracts with either single stocks or a basket of stocks, depending on your portfolio. Both derivatives are infinitely customizable to your situation.

How derivatives can enhance your estate plan

Lock-in tax-advantaged value

As you may know, if you pass away while holding a large, concentrated position in a particular asset, the value of that asset for estate tax purposes will be its value on the date of your demise, or the date six months after your demise, if that alternate value is lower, and the basis of the asset for income tax purpose is going to be "stepped up" to its estate tax value. However, any sale of the asset prior to the six month date will fix the alternate value of the asset. Use of a collar by the representative of your estate may allow your representative to retain the asset to determine whether the alternate value for estate tax purposes will be lower without risking loss of value to your estate.

Forward contracts can also be used for this purpose. The bottom line is that one must be careful to avoid "deemed sale" status. As a general rule of thumb, as long as the range in value is at least 20 percent of the value in which your representative entered into the contract, your representative will not be deemed to have sold the asset.

Lever up the value of intra-family transfers

There are derivative strategies that allow you to effectively leverage intra-family transfers while minimizing the impact of the gift tax on those transfers.

For example, you can split the two elements of a collar—the put and the call options—and put each of them into separate trusts. Depending on the movement of the underlying asset, one of these two positions is going to expire worthless, while the other option is going to create additional value.

By using this strategy, the initial value of the gift to the trusts could be relatively small, minimizing the impact of the gift tax. However, you will get a disproportionate value shift when either of the two derivatives matures at greater value.

Enhance discounting for greater tax efficiency

Since there are many unknowns about the final value of a derivative at maturity, it can be effectively discounted for tax purposes within an estate plan.

The ability to customize the language of the documentation that governs a derivative can be an opportunity to enhance discounting capabilities. When there are more unknowns about the final value of an investment, the more you can discount it for tax purposes—and pass along tax-effectively to a future generation.

For example, if you have $1 million in each of five hedge funds, tax authorities could value those assets at a total of $5 million, for gifting purposes. However, if you have derivatives based on underlying hedge funds that pay off in unique ways, such as 100% of the best performance, 20% of the worst performance, and a linear scale for performance in between, it is much more difficult to place a finite value on this type of structure for tax purposes. As a result, it is possible that the overall value of this portfolio could be significantly discounted, enabling you to gift securities more tax-efficiently.

Customize investments to work within the constraints of a trust

Many trusts have strict provisions that limit the trust's ability to borrow for investment purposes and use leverage. In many cases derivatives, because of their nature, can be customized to work within the constraints of a trust, to use leverage and to benefit from the potential of a long-term investment horizon without violating the terms of the trust.

For example, there are derivative products offered by major institutions that mirror the performance of a single hedge fund or a basket of hedge funds. The derivative's payoff is set by the major financial institution, the counterparty. Although it references the performance of the hedge funds, it is essentially a contract guaranteed by the institution, providing the security of principal that may be required by the strict terms of a trust.

In addition, there can also be a reduction in value of funds at risk. For example, if an investor or trust has $1 million in a hedge fund, the exposure is $1 million. However, you can buy a call option for $200,000 that replicates the performance of $1 million in the fund. In effect, you have actually lowered your asset allocation in that fund to $200,000 (and therefore the risk), and freed up $800,000 which is now available to invest elsewhere.

When it's time to go beyond the basics

As we have seen, derivatives can be used to broaden your estate and tax planning options, as well as to hedge risk. However, derivatives are a sophisticated strategy to consider after you have covered the fundamental components of estate planning such as wills, powers of attorney, and proper trust structures—and there may be additional opportunities available from a tax planning perspective.

These products are constantly evolving, and their income tax treatment can be complex, so it is vitally important to compare offerings and to use professional advisors. Investment banks offer different pricing models and a wide range of derivative products. Remember: the larger the transaction, the more you will want to diversify your counterparty choices to further reduce risk.

Derivatives offer many advantages to clients who are comfortable with a certain amount of complexity in order to reap tax savings and inter-generational wealth transfer benefits. Derivatives can enable you to defer tax consequences…lever up the value of intra-family transfers…enhance discounting for tax purposes…and boost long-term returns within a trust.

Your Harris myCFO advisor can help you determine when and where to use derivatives, identify the most qualified providers, and assist you with the selection and ongoing monitoring of derivatives as you move forward.

COMMONLY USED TERMS

Options: An option is a contract that gives the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price on or before a certain date. An option, just like a stock or bond, is a security. It is also a binding contract with strictly defined terms and properties.

Puts: A Put option is a contract that gives the buyer the right to sell shares of an underlying stock at a predetermined price for a preset time period. The seller of a Put option is obligated to buy the underlying security if the Put buyer exercises his or her option to sell on or before the option expiration date.

Calls: A Call option is a contract that gives the buyer the right to buy shares of an underlying stock at a predetermined price (the strike price) for a preset period of time. The seller of a Call option is obligated to sell the underlying security if the Call buyer exercises his or her option to buy on or before the option expiration date.

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