



NORTHERN  
TRUST

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# Goblins Lamentation List:

## *“Unscrambling” Installment Obligations*

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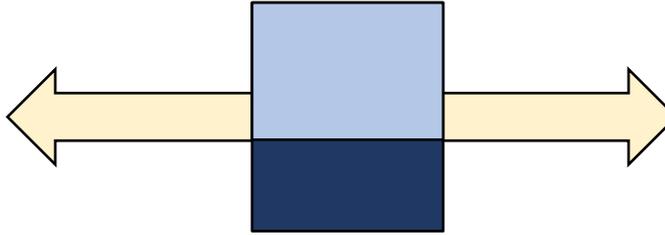
# Deferred Payment Obligations in Estate and Income Tax Planning

## Income Tax Consequences?

None

**Seller/Lender**

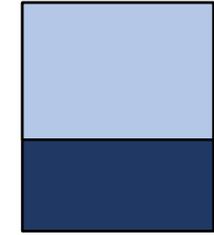
IDGT  
Installment  
Note



AB/FMV  
\$40x/\$100x

**Buyer/Borrower**

Intentionally  
Defective  
Grantor Trust



AB/FMV  
\$40x/\$100x

Gain  
Basis  
Interest

Taxable  
Installment  
Note



AB/FMV  
\$40x/\$100x

Taxable  
Non-  
Grantor Trust



AB/FMV  
\$100x/\$100x

None

Intra-Family  
Promissory  
Note



Intentionally  
Defective  
Grantor Trust



# The Installment Method: The Basics on Taxation

<b>FMV</b> \$100,000
<b>AB</b> \$40,000

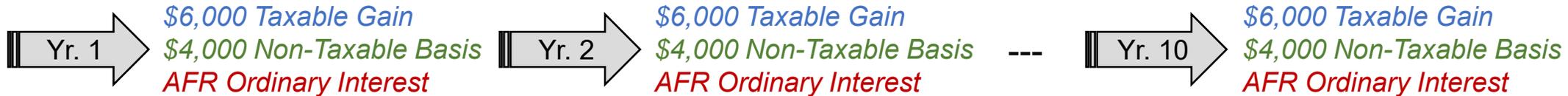
$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit (Selling Price - Adjusted Basis)}}{\text{Contract Price}}$$

Gross Profit = \$100,000 - \$40,000 = \$60,000  
 Contract Price = \$100,000  
 Gross Profit Percentage = \$60,000 ÷ \$100,000 = 60%

Installment method applies by **default** unless the seller elects out

Selling Price and Contract Price are **equal** if there is **no debt**

## 10-year fixed payment term [\$10,000 annual payment + adequate interest (AFR)]

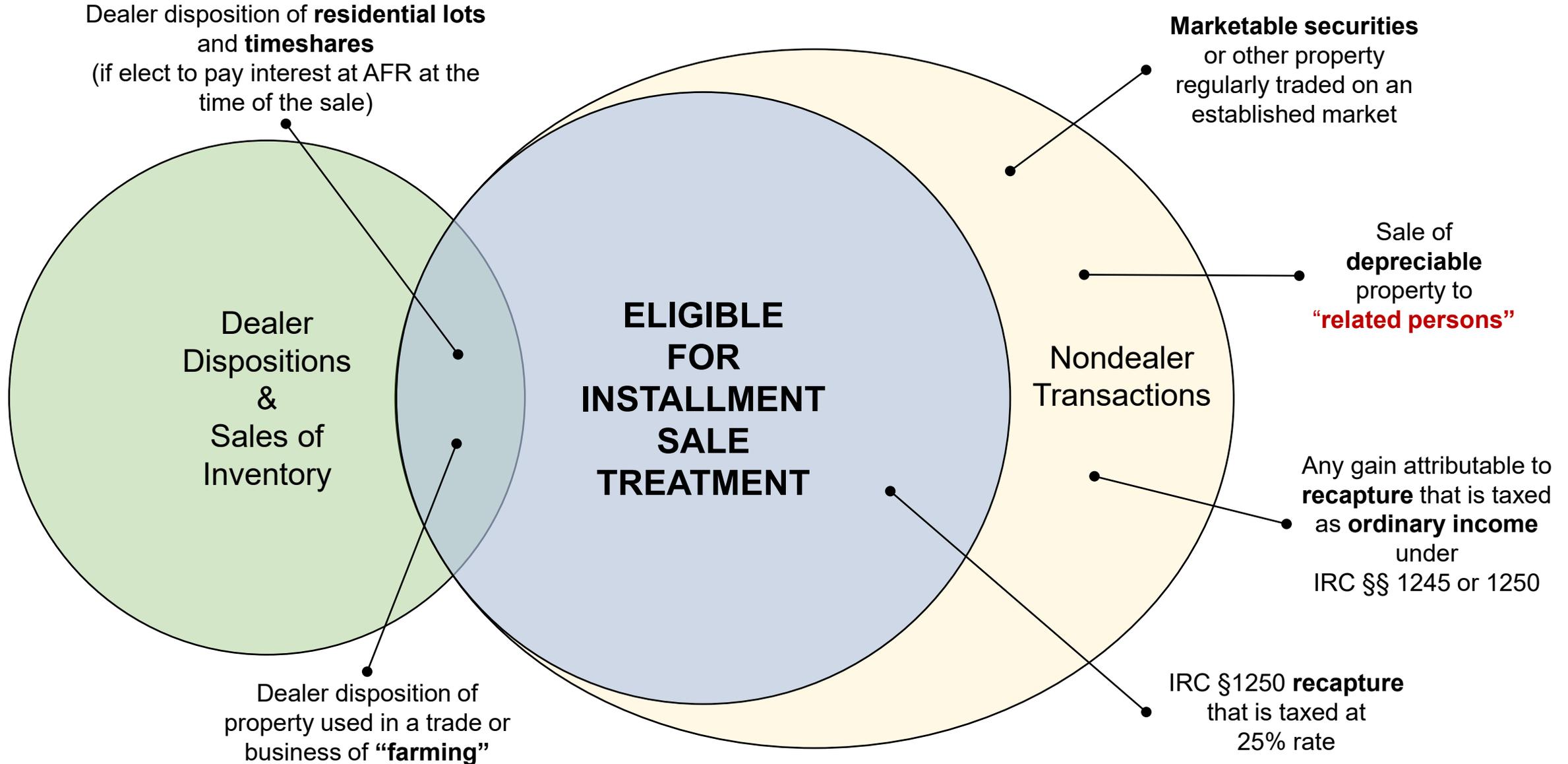


Term must be **less than actuarial life expectancy** (GCM 39503)

## 30-year interest-only "balloon" [\$100,000 in year 30]



# (IN)Eligibility for the Installment Method: Assets & Transactions



# Special Rule for Nondealers: The Interest Charge [§ 453A(a)(1)]

IRC § 453A(a)(1): interest on the deferred tax liability subject to a \$5 million threshold of outstanding obligations

<b>FMV</b> \$30,000,000
<b>AB</b> \$6,000,000

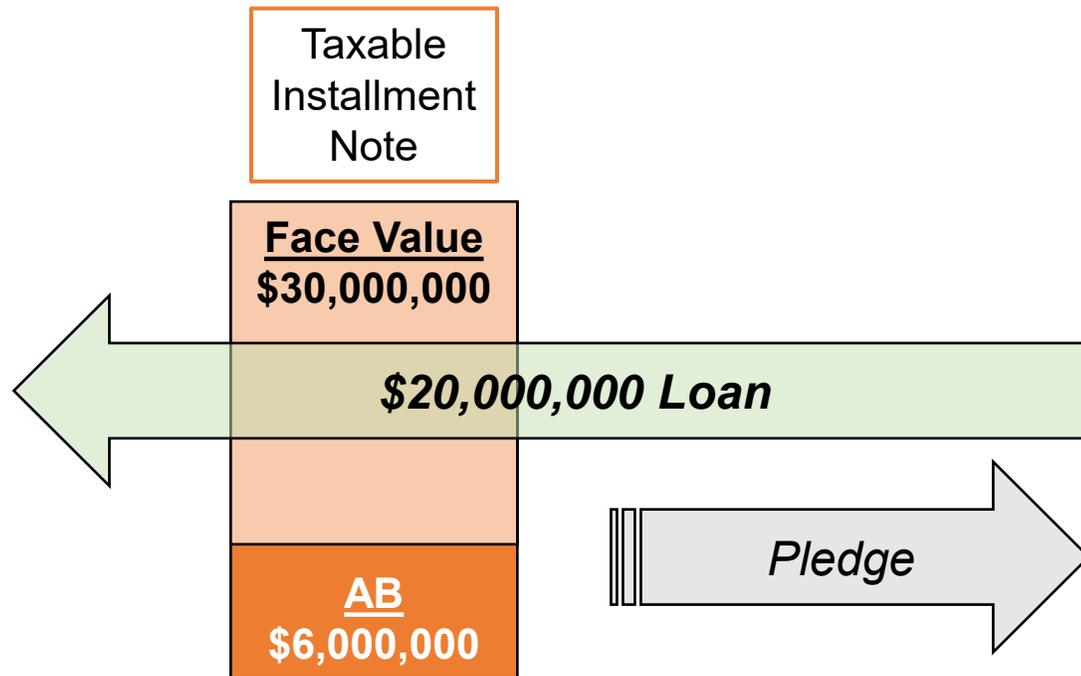
$$\begin{array}{ccccccc} \text{Interest Charge} & = & \text{Underpayment Rate} & \times & \text{Applicable Percentage} & \times & \text{Deferred Tax Liability} \\ & & \swarrow & & \downarrow & & \searrow \\ & & \text{short-term AFR plus 3\%} & & \text{face amount of all obligations} & & \text{unrecognized gain} \\ & & \text{for last month of year} & & \text{less \$5 million} & & \times \\ & & \text{(7.55\%-12/2022)} & & \div & & \text{maximum tax rate} \\ & & & & \text{face amount of all obligations} & & \text{for the taxpayer that year} \end{array}$$

$$\text{Interest Charge} = 7.55\% \times 83.3\% (\$25\text{MM}/\$30\text{MM}) \times \$4,800,000 (\$24\text{MM} \times 20\%) = \$302,000$$

- **Interest Charge:**
  - Is a dollar-for-dollar increase in the tax (not “interest” as an ordinary income item)
  - Calculation does NOT include the 3.8% net investment income tax
  - Is NOT deductible
  - Applies every taxable year including the year of sale
  - Will go down over time unless the obligation is an interest-only “balloon”
  - Increases if interest and income tax rates rise in the future
- **\$5 Million Threshold:**
  - Applies on a taxpayer-by-taxpayer basis (even among spouses)
  - Is based on the face amount of the obligations (not unrecognized gain)

# Special Rule for Nondealers: The Pledge Rule [§ 453A(a)(2)]

IRC § 453A(a)(2): Pledging a Taxable Installment Note for a loan will be treated as a payment on the obligation



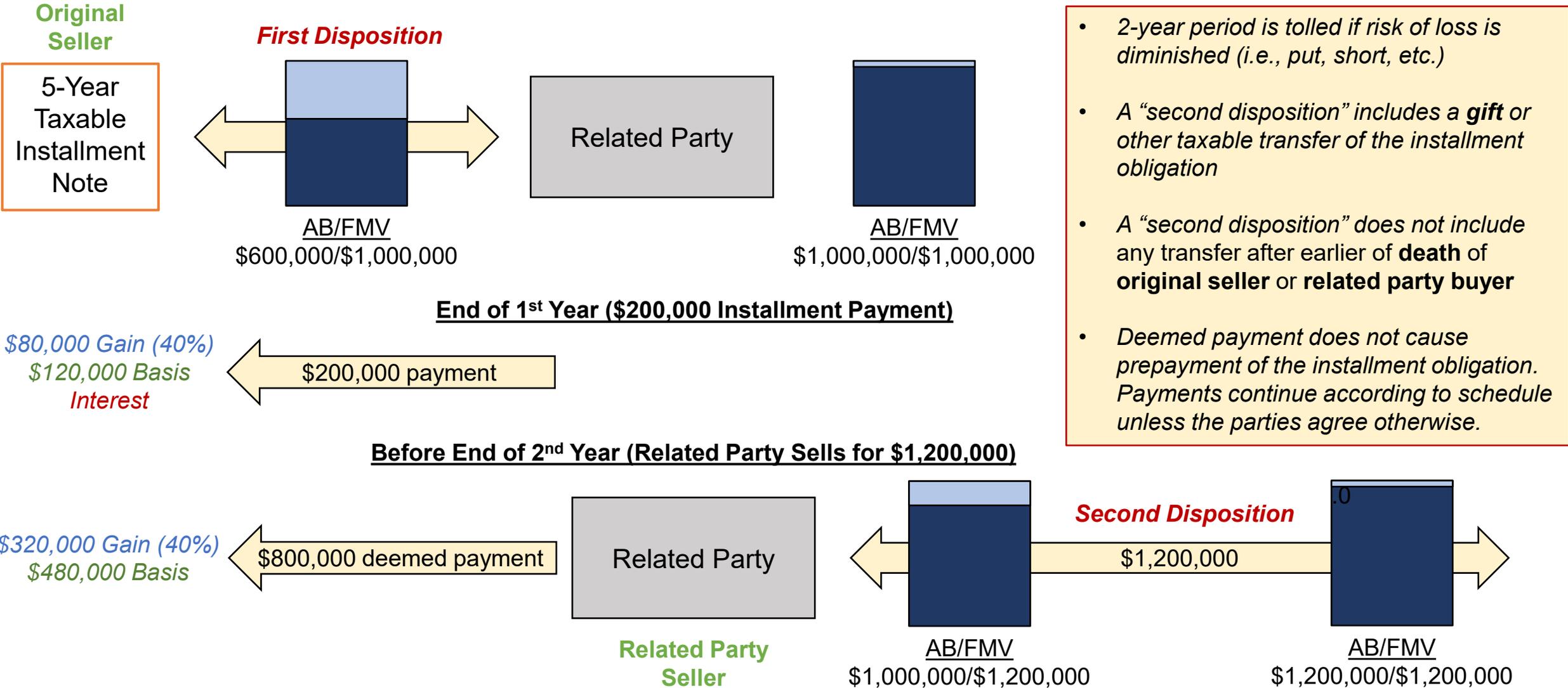
## Deemed Payment of \$20 Million

$$\begin{aligned} &80\% \text{ Gross Profit Percentage } (\$24\text{MM}/\$30\text{MM}) \\ &\quad \times \\ &\$20\text{MM Deemed Payment} \\ &\quad = \\ &\$16 \text{ MM Capital Gain} \\ &\quad + \\ &\$4 \text{ MM Non-Taxable Basis} \end{aligned}$$

*Unclear whether the pledge of an interest in a partnership that holds a Taxable Installment Obligation will trigger the Pledge Rule*

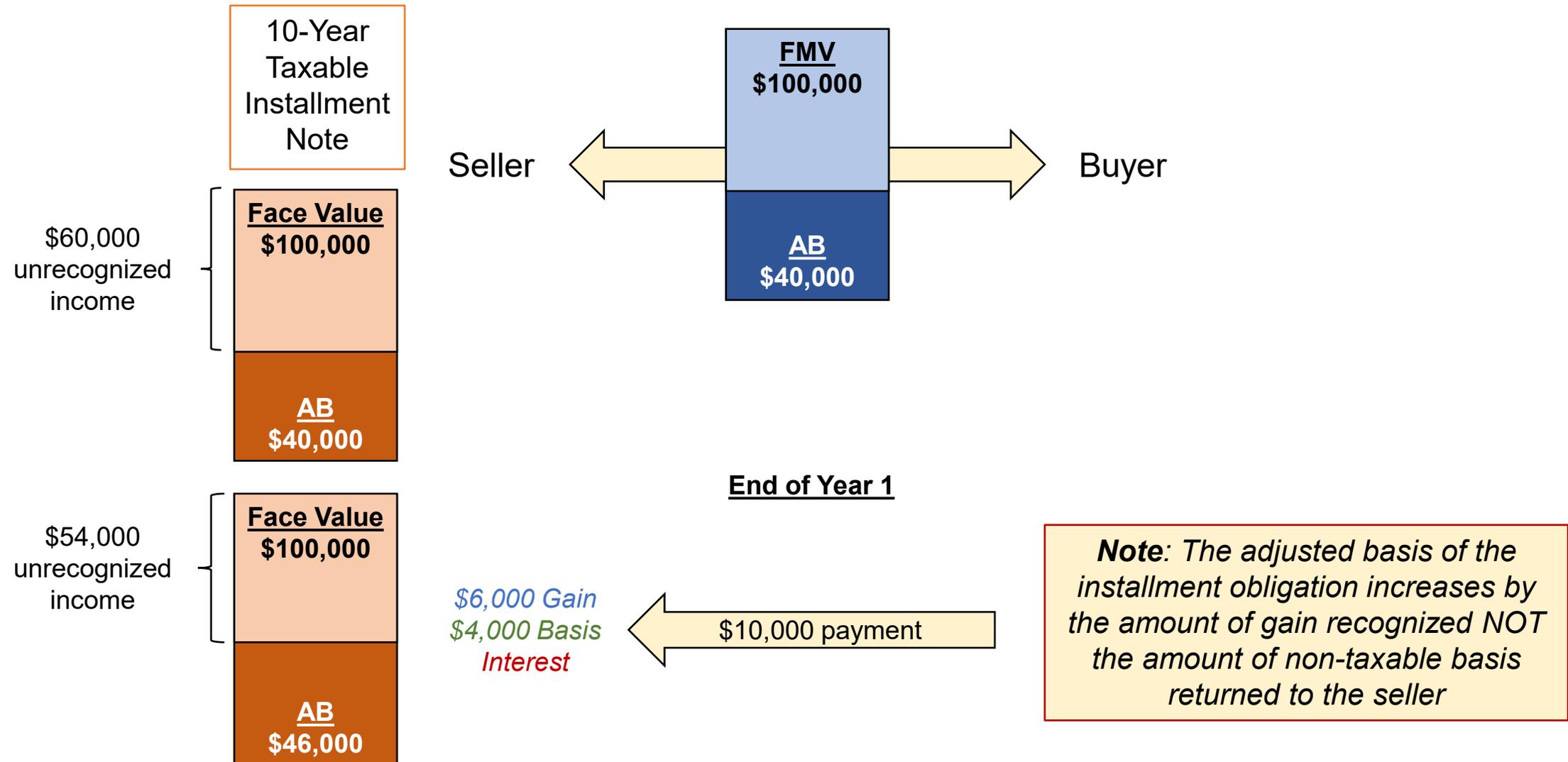
# Resale of Purchased Property by a Related Person in 2 Years

IRC § 453(e): Resale of purchased property by a related party within 2 years of the first sale treated as a payment



# Adjusted Basis of Taxable Installment Obligations

IRC § 453B(b): adjusted basis is the excess of the face value over the unrecognized income if satisfied in full



# Transfers at Death, Gifts, and Taxable Dispositions

## Death-Related Transfers

- Generally, NOT a taxable disposition
- Income in respect of a decedent (IRD)
- Distribution to the obligor is a taxable disposition
- Distribution to a beneficiary as part of a residuary or specific bequest is NOT a taxable disposition
- Transfer to a joint tenant by right of survivorship is NOT a taxable disposition

## Taxable Dispositions

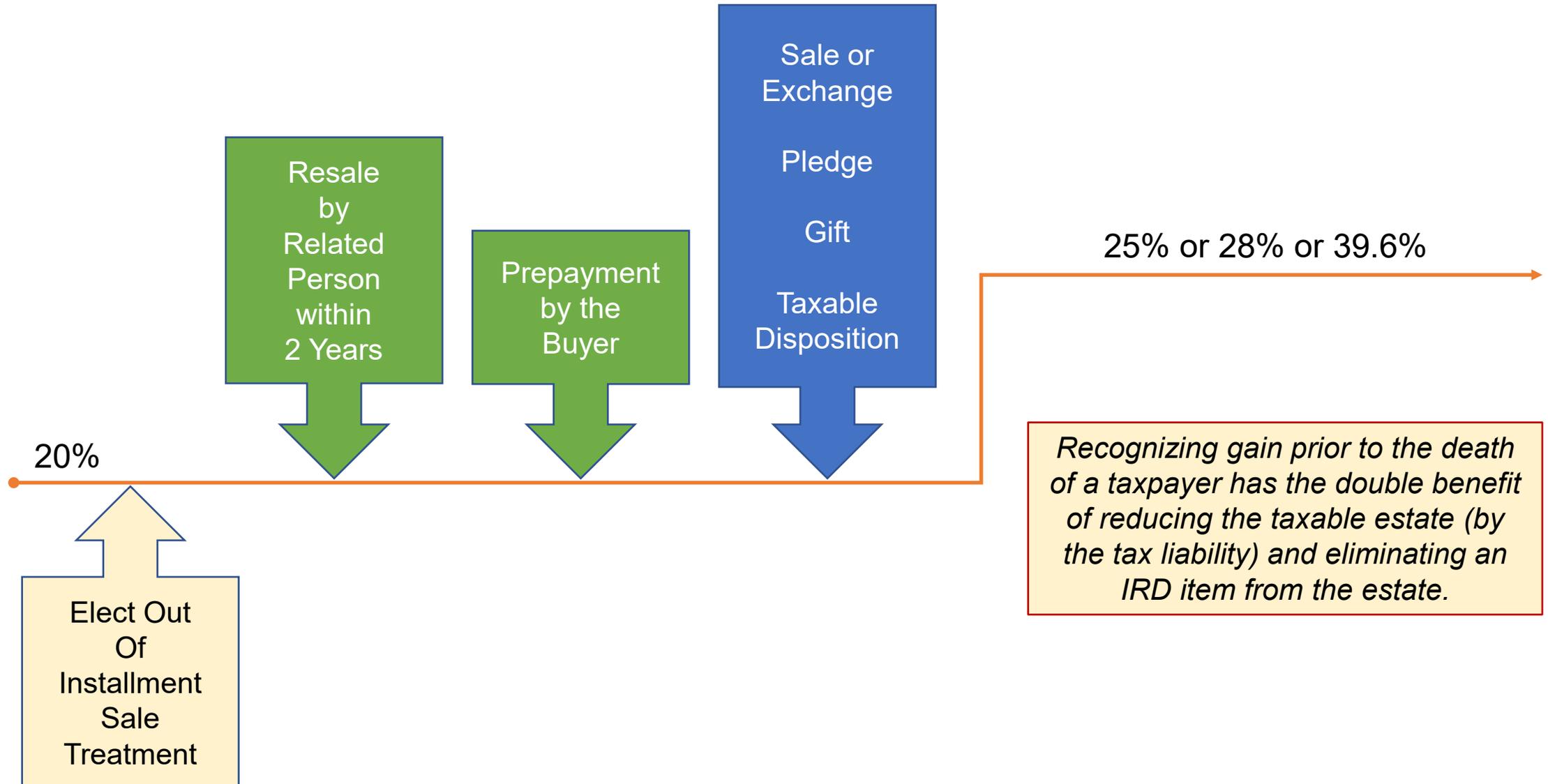
- Sale or exchange
- Gifts
- Contributions to and distribution from a non-grantor trust
- Sale or exchange of an interest in a partnership that holds an installment obligation
- Cancellation of the obligation

## Non-Taxable Dispositions

- Transfers between grantor and grantor trust (as to both income and principal)
- Transfers to a spouse (but NOT a trust for the benefit of a spouse)
- Transfers to a former spouse incident to divorce
- Non-substantial modifications that do not “materially change” rights of the seller
- § 721 contributions and § 731 distributions (partnerships)
- § 351 contributions and § 361 distributions (corporations)

- *Amount of gain or loss on a taxable disposition is either the **amount realized** or the **fair market value** of the obligation.*
- *If the obligation is **cancelled**, and the obligor and obligee are **related persons**, then the fair market value will be deemed to be **no less than the face amount** of the obligation.*
- *There does NOT seem to be a corresponding rule for a **gift** or other transfer to a related person (i.e., **valuation discounts** can reduce the resulting gain on a taxable disposition).*

# Flexibility to Determine When Gain Is Recognized



# Comparing Installment Obligations and Promissory Notes

	Taxable Installment Obligation	IDGT Installment Note	Intra-Family Promissory Note
Treatment at Death of Holder	Income in Respect of a Decedent (No § 1014 Basis Adjustment)	Capital Asset (§ 1014 Basis Adjustment)	Capital Asset (§ 1014 Basis Adjustment)
Tax Basis of Note	Initially equal to the basis of asset and adjusted for remaining unrealized gain	Initially equal to basis of asset sold to IDGT, possibly adjusted for remaining unrealized gain due to payments, and the basis of swapped assets	For <b>funded</b> loans, basis of loaned cash or property.  For <b>unfunded</b> loans (promises to pay), <b>likely</b> zero (unlikely equal to the obligation amount)
Treatment of Gift Transfer of the Note	Taxable disposition. Recognize gain equal to difference between the basis and the fair market value of the installment obligation.	<b>Likely</b> Not a taxable disposition with carryover basis.	Not a taxable disposition with carryover basis.

# Grantor to Non-Grantor During Grantor's Lifetime

## Conversions: What We Know and What We Don't Know

- Trust assets are now “owned” (for tax purposes) by another taxpayer (non-grantor trust, grantor, or § 678 beneficiary).
- How does that change of “ownership” occur?
- If the change in ownership is a deemed transfer, is it treated like a gift under § 1015 (i.e., carry-over basis)?
- If the transferred asset is subject to debt and debt is in excess of basis, is gain recognized?

## Rev. Rul. 77-402

### ■ Grantor Trust

- A contributes funds to irrevocable Trust (T)
- Trustee purchases interest in real estate partnership (P)
- P purchases real estate with recourse and nonrecourse debt
- P elects accelerated depreciation (deducted on A's return)

### ■ Conversion to Non-Grantor Trust

- Outside basis of interest in P is zero and P starts generating net income
- A's share of partnership liabilities are in excess of the A's outside basis
- A renounces grantor trust powers

[A]t the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have **transferred ownership** of the interest in P to T, now a separate taxable entity, independent of its grantor.

A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest ... immediately prior to the change in T's tax status.

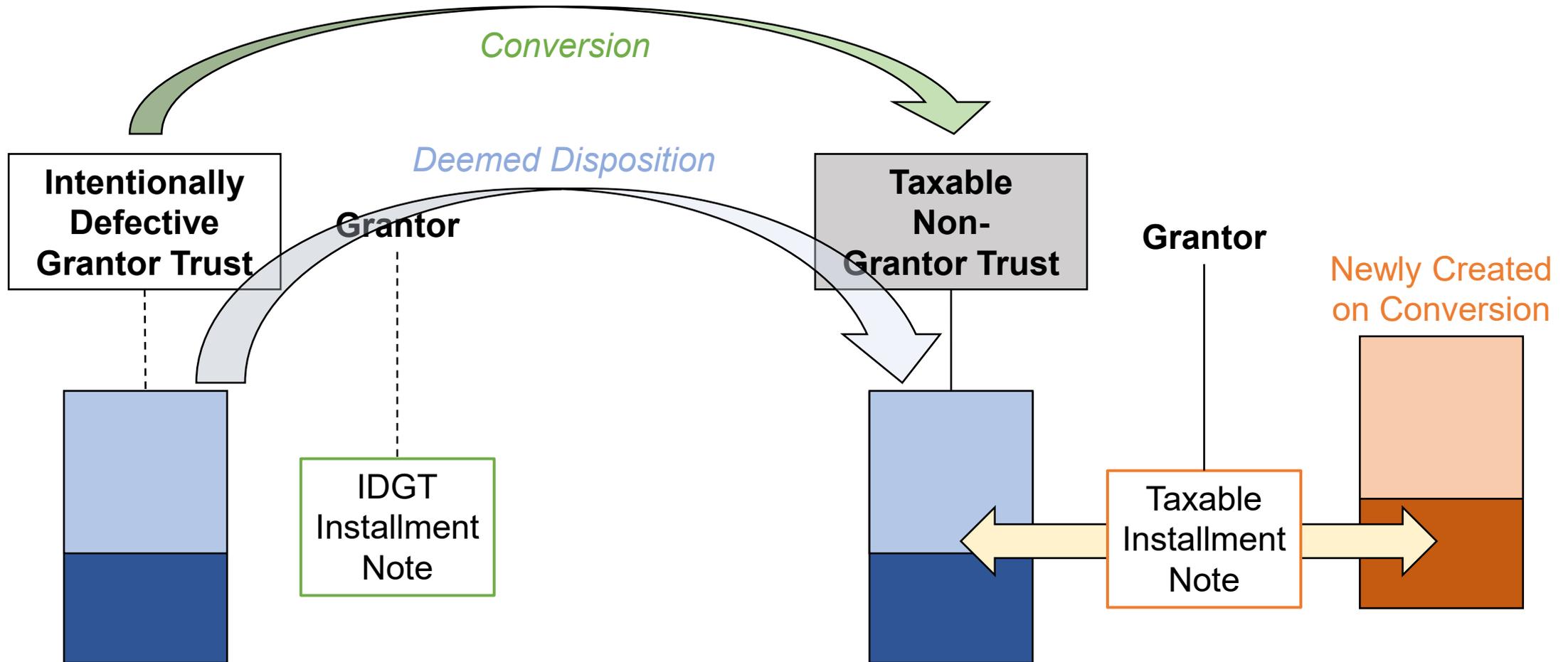
*Crane, Tufts, and* Treas. Reg. § 1.1001-2(c), Ex. 5 vs. *Madorin*

## Treas. Reg. § 1.1001-2(a)(4)(i) & (iii)

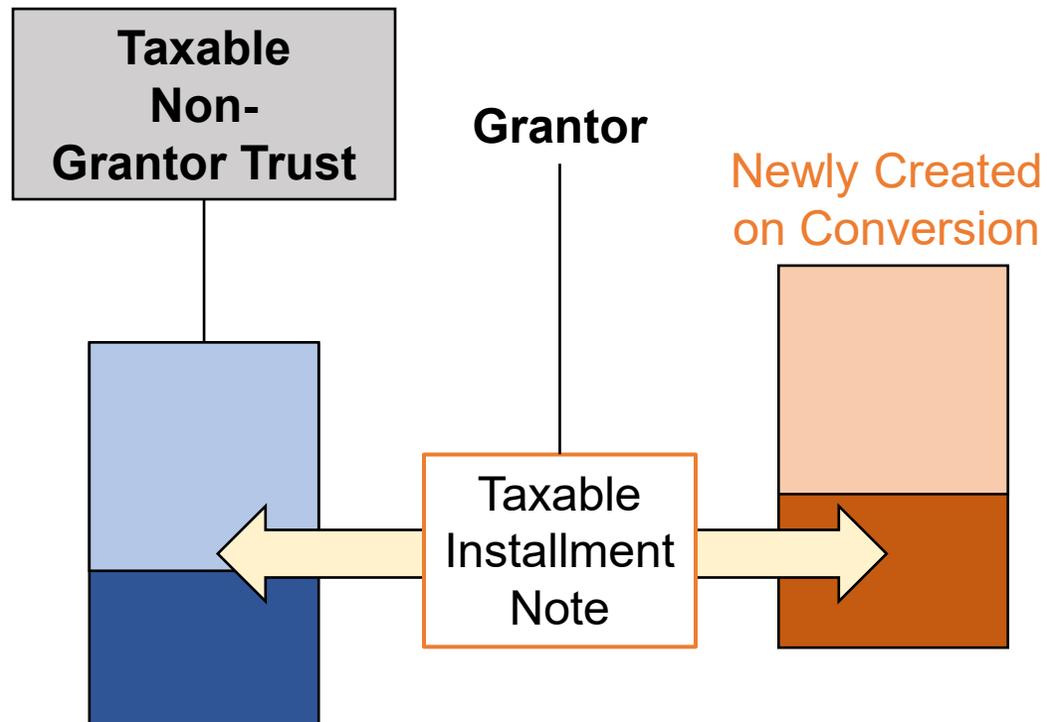
The sale or **other disposition of property** that secures a nonrecourse liability discharges the transferor from the liability. A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject.

# When IDGT Installment Notes Become Taxable Obligations

IRC § 453(b)(1): “installment sale” is a “disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.”



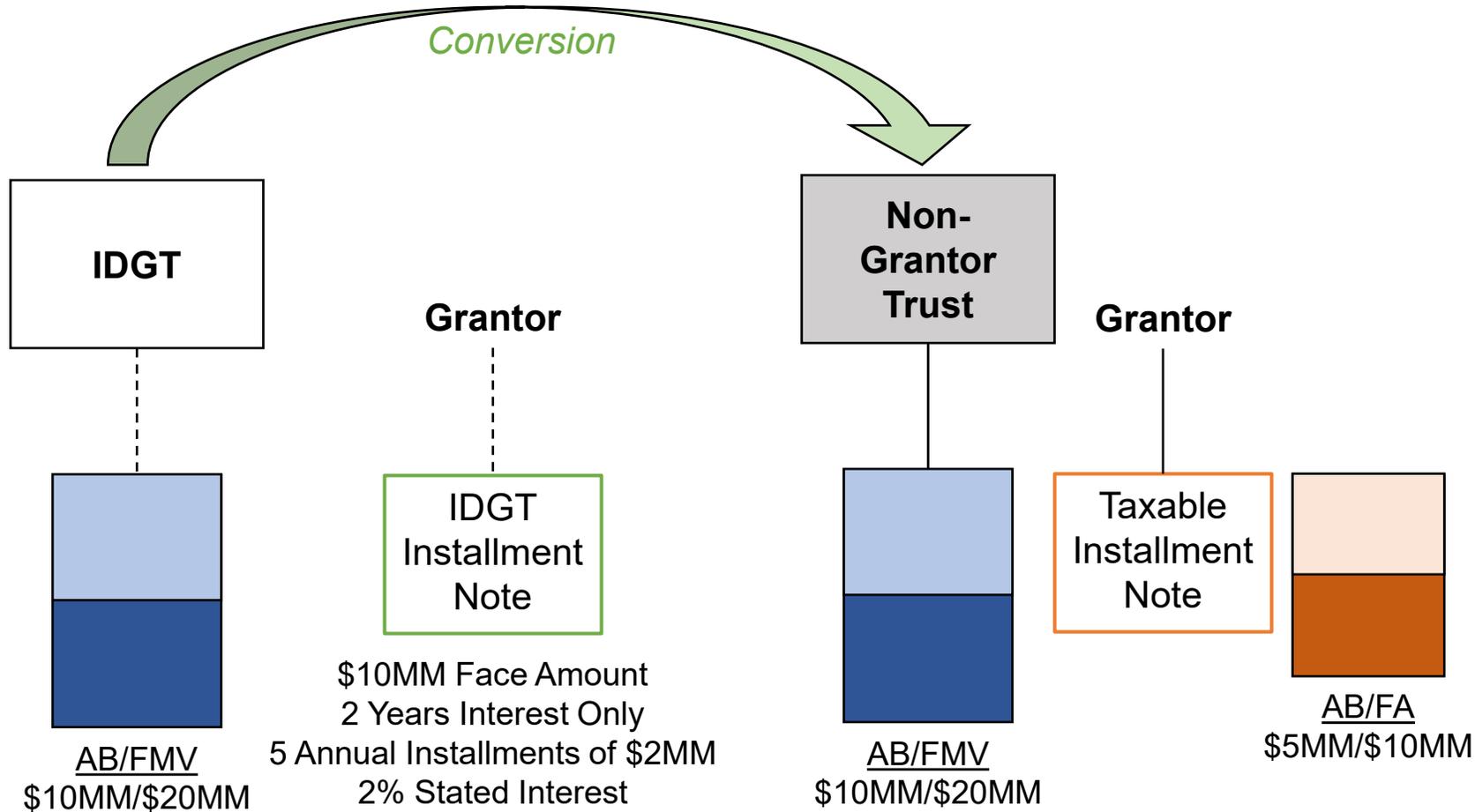
# What Are the Consequences When IDGT Notes Go Bad?



- Deemed disposition is an installment sale, and the grantor holds a Taxable Installment Obligation.
- If the face amount of the obligation is in excess of the basis of the assets, then gain will be recognized to that extent.
- If the disposed property is not eligible for the installment method (i.e., marketable securities), then gain will be recognized based on the fair market value.
- Imputed (understated) interest rules likely apply.
- Interest Charge Rule may apply.
- Pledge Rule will apply.
- The disposed property may be subject to the 2-year resale rule by a related party.
- Gifts and other transfers may be taxable dispositions.
- Obligation converts from a capital asset (IDGT Note) to income in respect of a decedent (IRD).

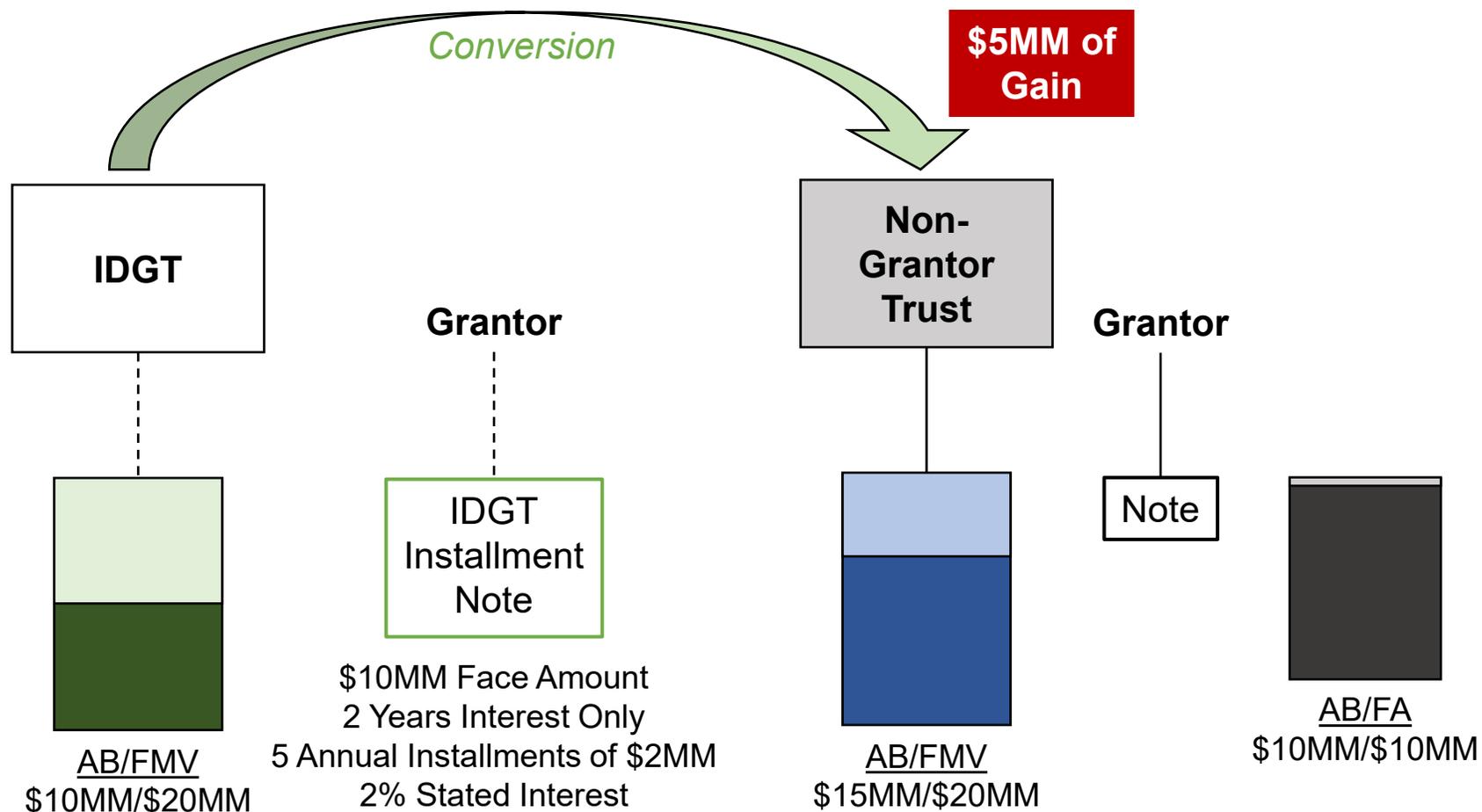
CONVERSION FROM GRANTOR TRUST  
TO NON-GRANTOR TRUST  
DURING THE LIFE OF THE GRANTOR

# When Debt Is Not in Excess of Basis



- If the applicable AFR is 5% at the time of the conversion, then there will be imputed interest each year (additional 3%=\$300,000 of additional interest)
- Interest Charge Rule applies (at 7% underpayment rate and 20% capital gain rate=\$35,000)
- Obligation is income in respect of a decedent (IRD) if grantor dies with obligation
- If non-grantor trust sells the property within 2 years of the conversion, there will be a deemed taxable payment to grantor
- Subject to the Pledge Rule and taxable disposition rules

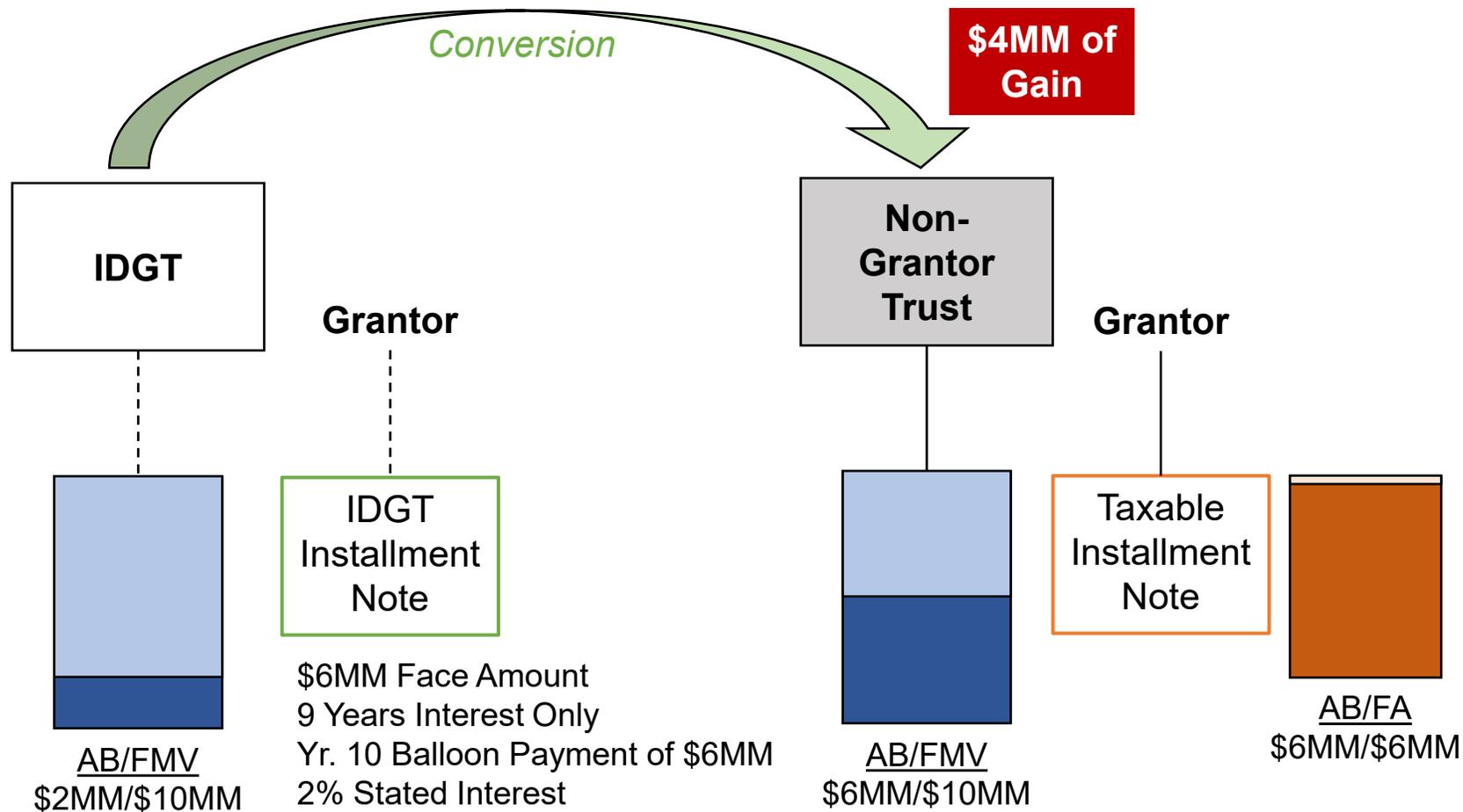
# When Property Is Not Eligible for Installment Sale Treatment



- If the applicable AFR is 5% at the time of the conversion, then there will be imputed interest each year (additional 3%=\$300,000 of additional interest)
- Grantor holds a note that is not a Taxable Installment Note (akin to an Intra-Family Promissory Note)
- Interest Charge and Pledge Rules do not apply
- Note is a capital asset (not IRD)

Marketable Securities: Not eligible for installment sale treatment

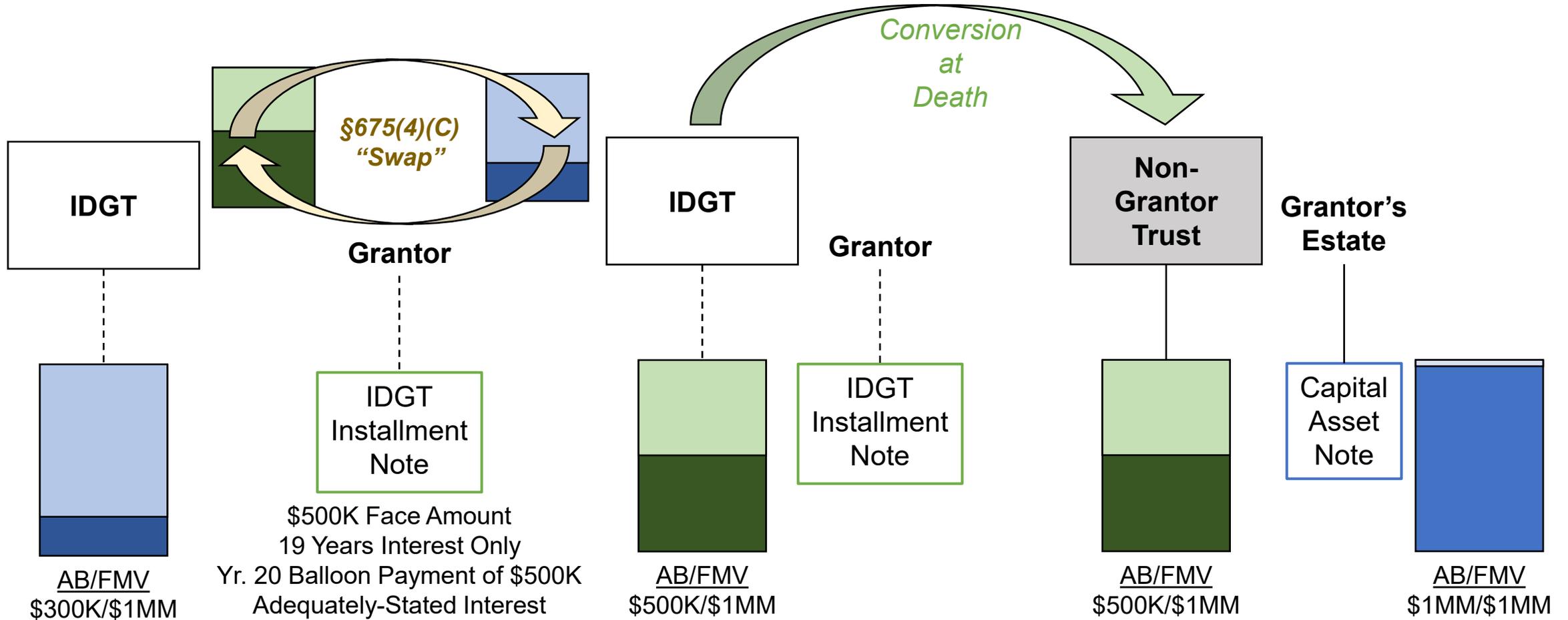
# When Debt Is in Excess of Basis



- If the applicable AFR is 5% at the time of the conversion, then there will be imputed interest each year (additional 3%=\$300,000 of additional interest)
- Interest Charge and Pledge Rules technically apply but no extra taxes will be due
- Obligation is income in respect of a decedent (IRD) if grantor dies with obligation. No additional taxes due unless estate claims valuation discount on the obligation
- If non-grantor trust sells the property within 2 years of the conversion, no additional taxes due to grantor
- No additional taxes if there is a taxable disposition

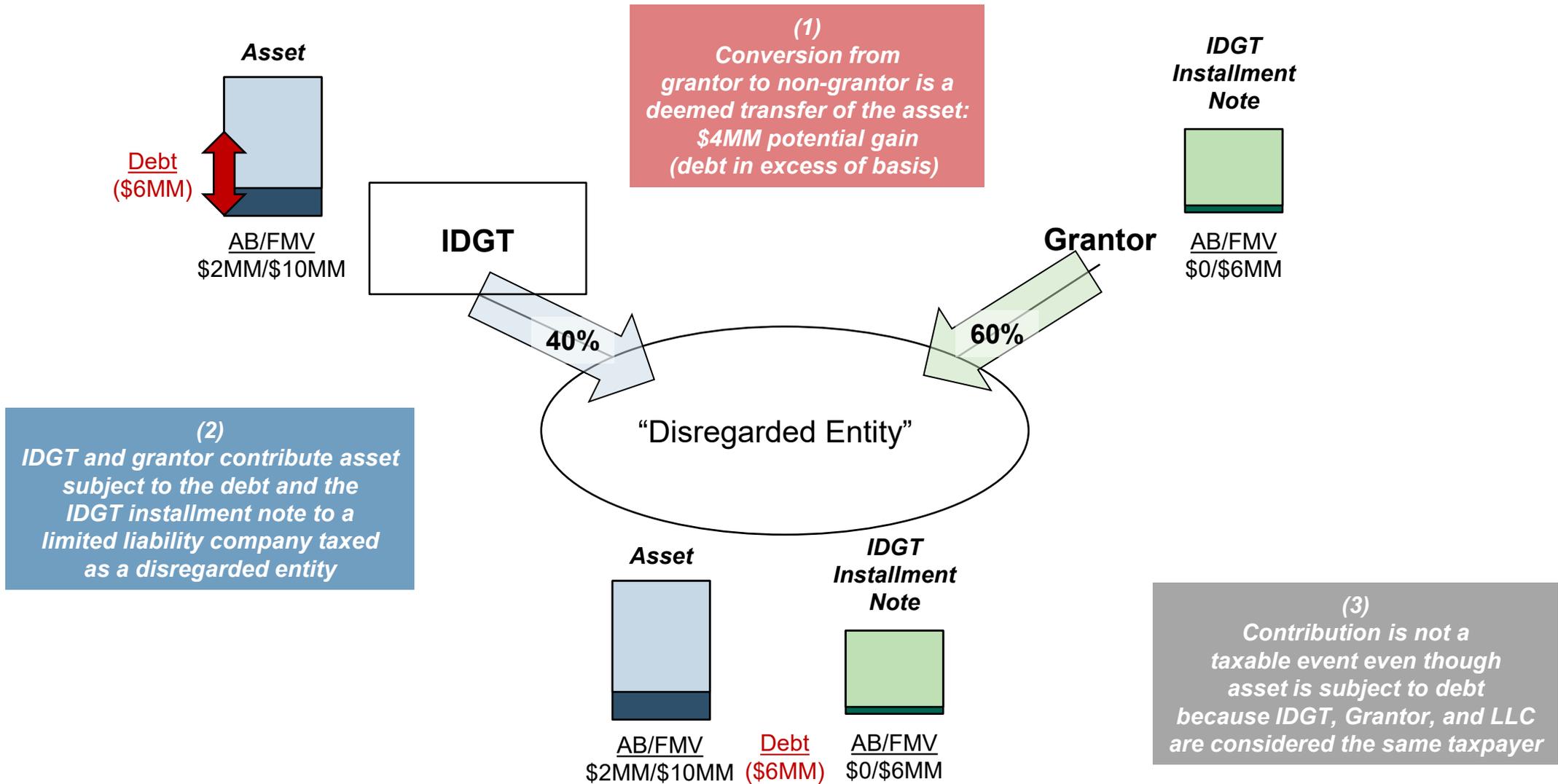
AVOIDING GAIN  
UPON THE DEATH OF  
THE GRANTOR

# Debt in Excess of Basis: Swapping Assets



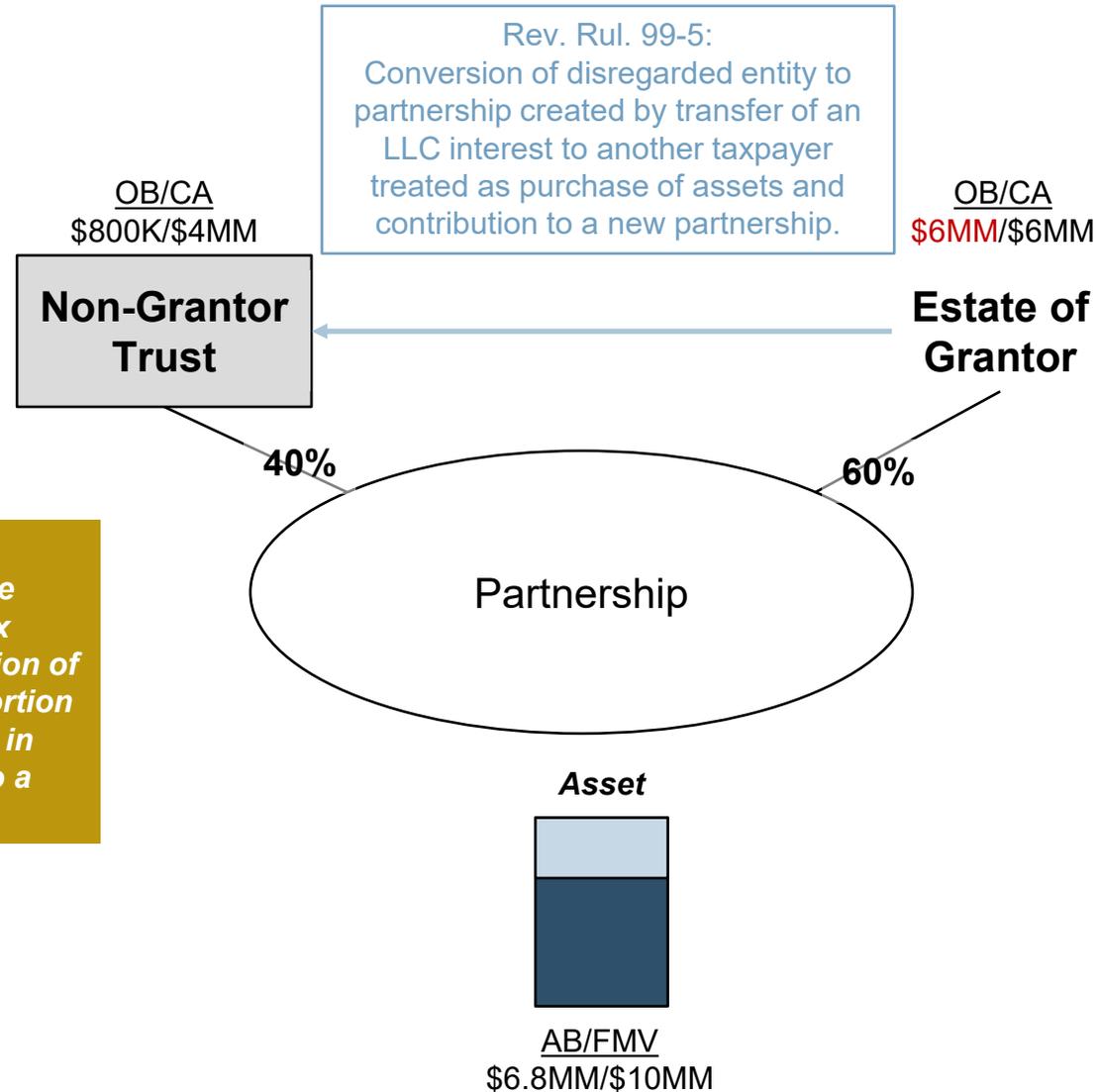
**\$200K  
Potential Gain**

# Making the Debt Disappear with a Disregarded Entity





# Death of Grantor Converts Disregarded Entity to a Partnership



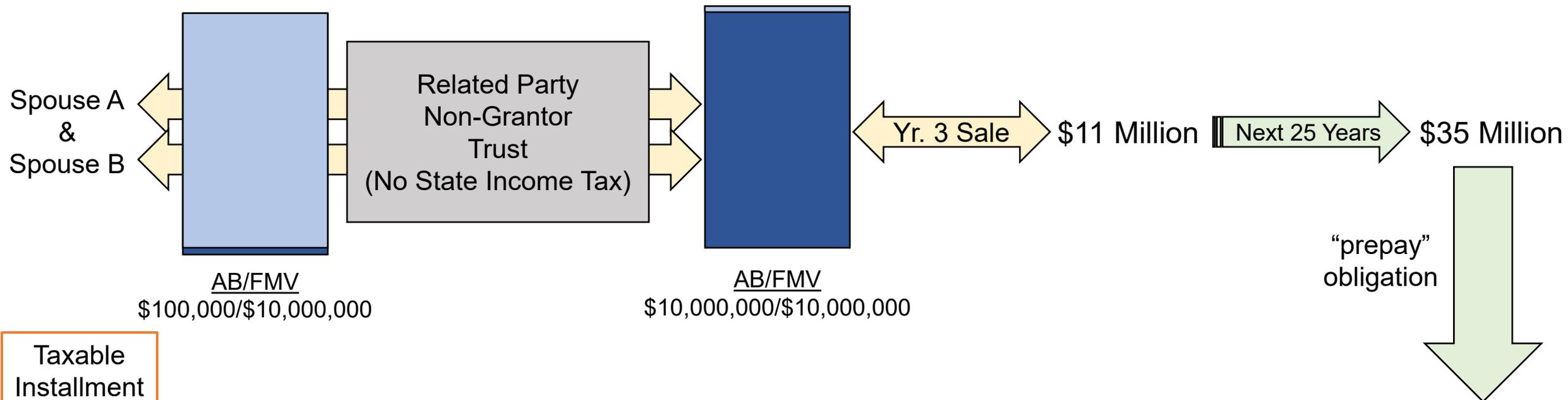
(5)  
Grantor's death converts the LLC to a partnership for Tax Purposes. Treated as the Creation of a New Partnership: grantor's portion of the asset gets a "step-Up" in basis, and it is contributed to a newly formed partnership.

(6)  
End Results:

- a) No gain on the grantor's death;
- b) Asset gets a partial basis adjustment under § 1014; and
- c) No installment note included in grantor's estate.

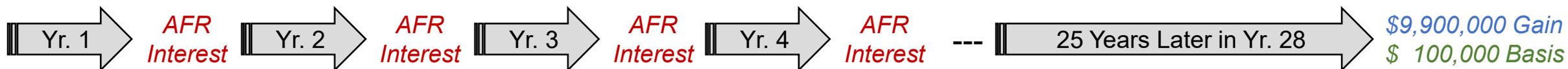
NOT “RUSHING”  
RELATED PARTY SALES

# Not “Rushing” Related Party Sales



Taxable Installment Notes

**30-year interest-only “balloon” [\$10,000,000 in year 30]**



- Long term income tax deferral at both Federal and state levels
- No Interest Charge payable
- \$25 million of wealth transfer
- Flexibility to “prepay” at any time for any reason (i.e, tax rate increase)
- Complete avoidance of state income tax if A and B move to a no income tax state

What if you convert from a non-grantor trust to a grantor trust?

CCA 200923024  
PLR 201730018

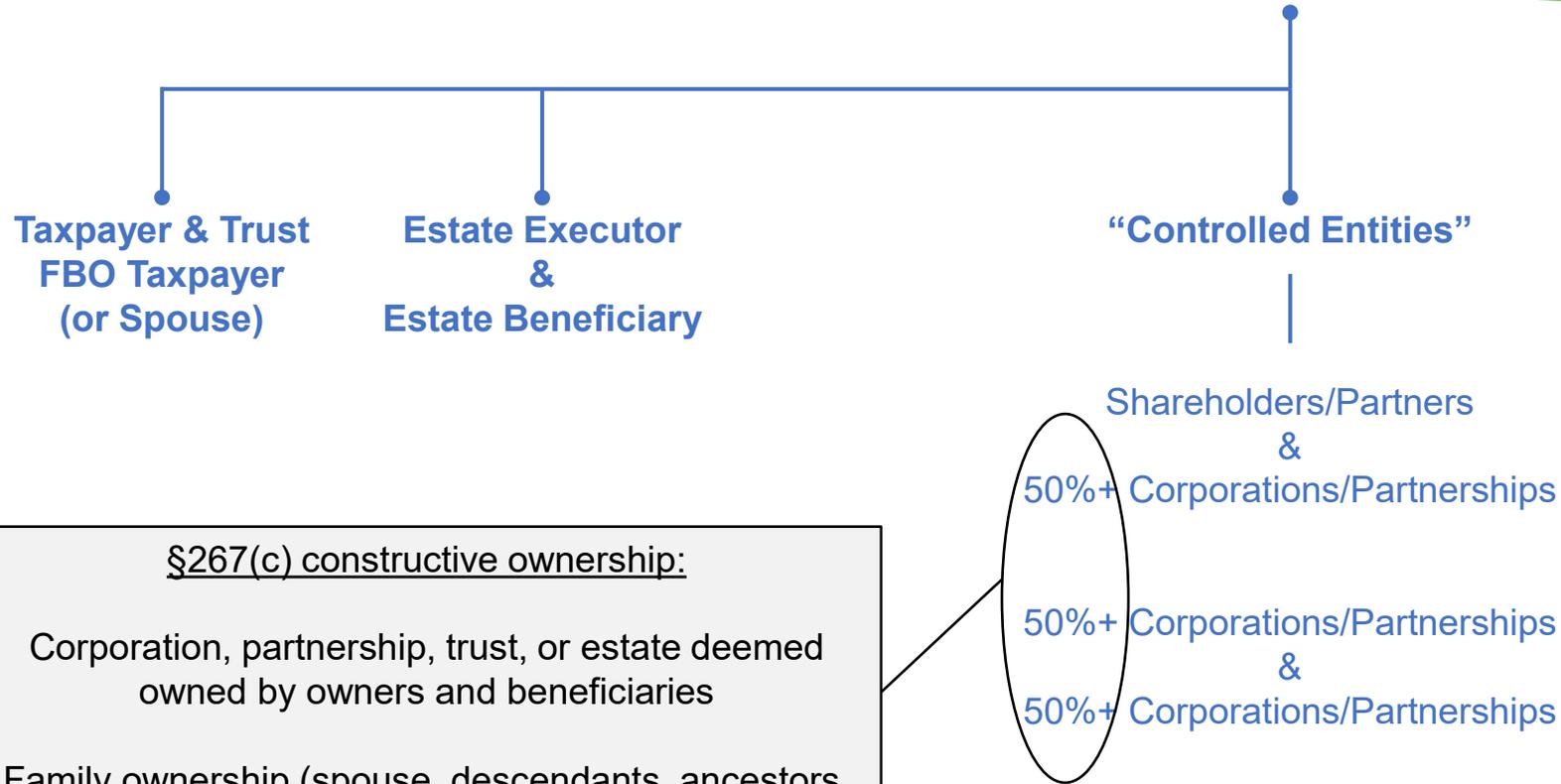
DEPRECIABLE PROPERTY SALES  
TO “RELATED PERSONS”:

REFRESHING BASIS &  
RESURRECTING DEPRECIATION

# “Related Person” under Section 453(g)

§ 453(e) & § 453(f)(1) “Related Person” ≠ § 453(g) “Related Person”

§ 453(g) “Related Person” = § 1239(b) + § 707(b)(1)(B)

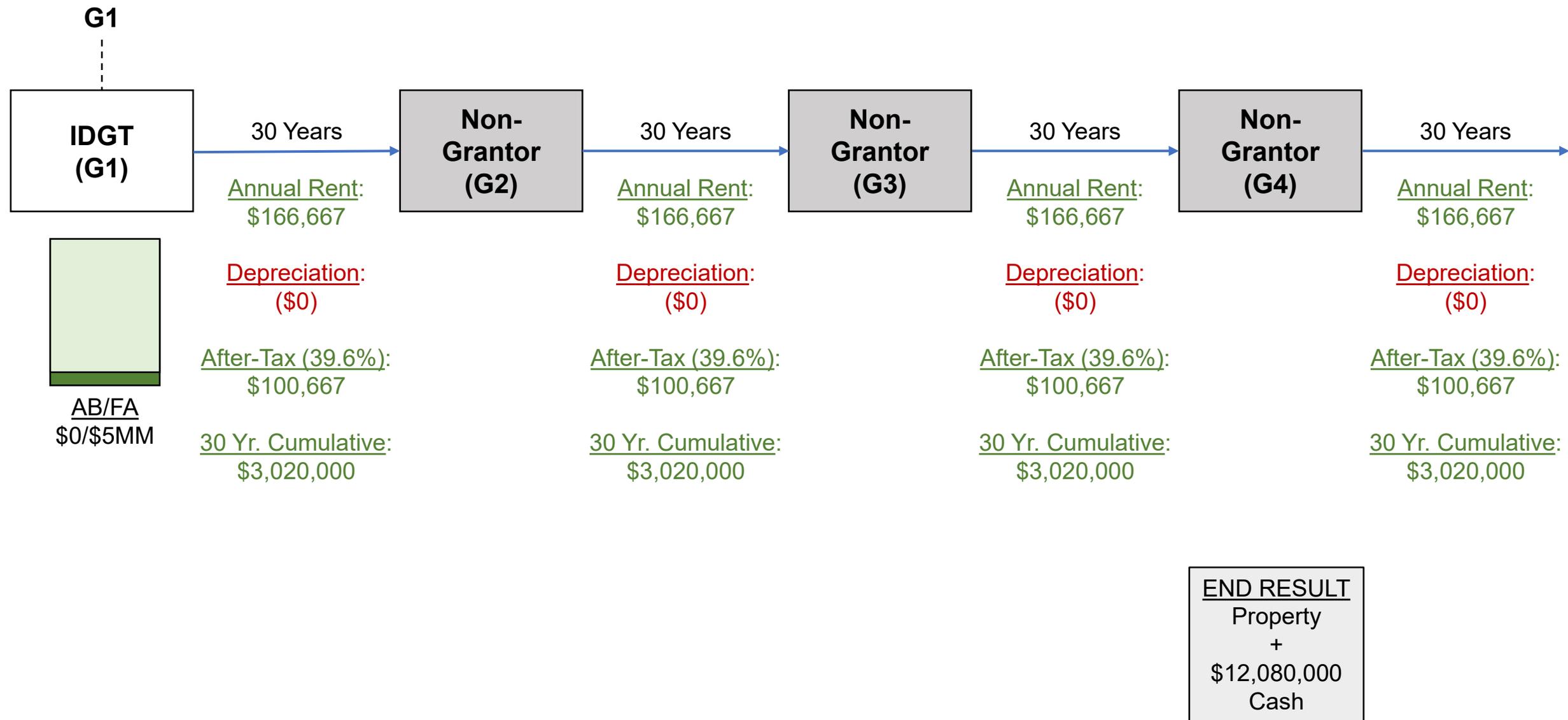


Only applies between 50%+ partnerships (with constructive family ownership) but NOT corporations and trusts

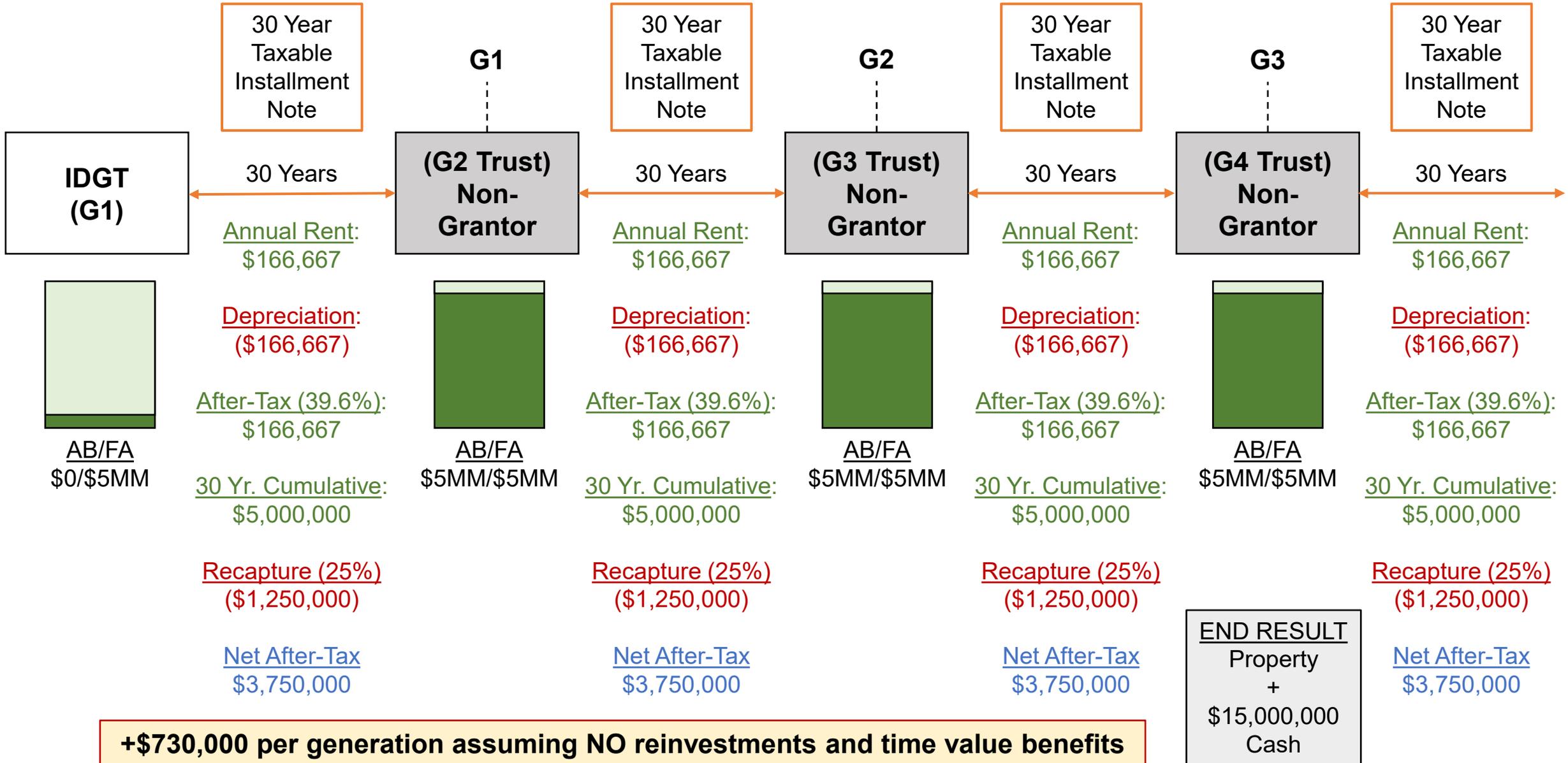
§267(c) constructive ownership:  
 Corporation, partnership, trust, or estate deemed owned by owners and beneficiaries  
 Family ownership (spouse, descendants, ancestors, and siblings) deemed owned by taxpayer

NOT §453(g) “Related Persons”  
*Children*  
*Descendants*  
*Trust for Children*  
*Trust for Descendants*

# When Depreciated Property Is Held by an IDGT Dynasty Trust

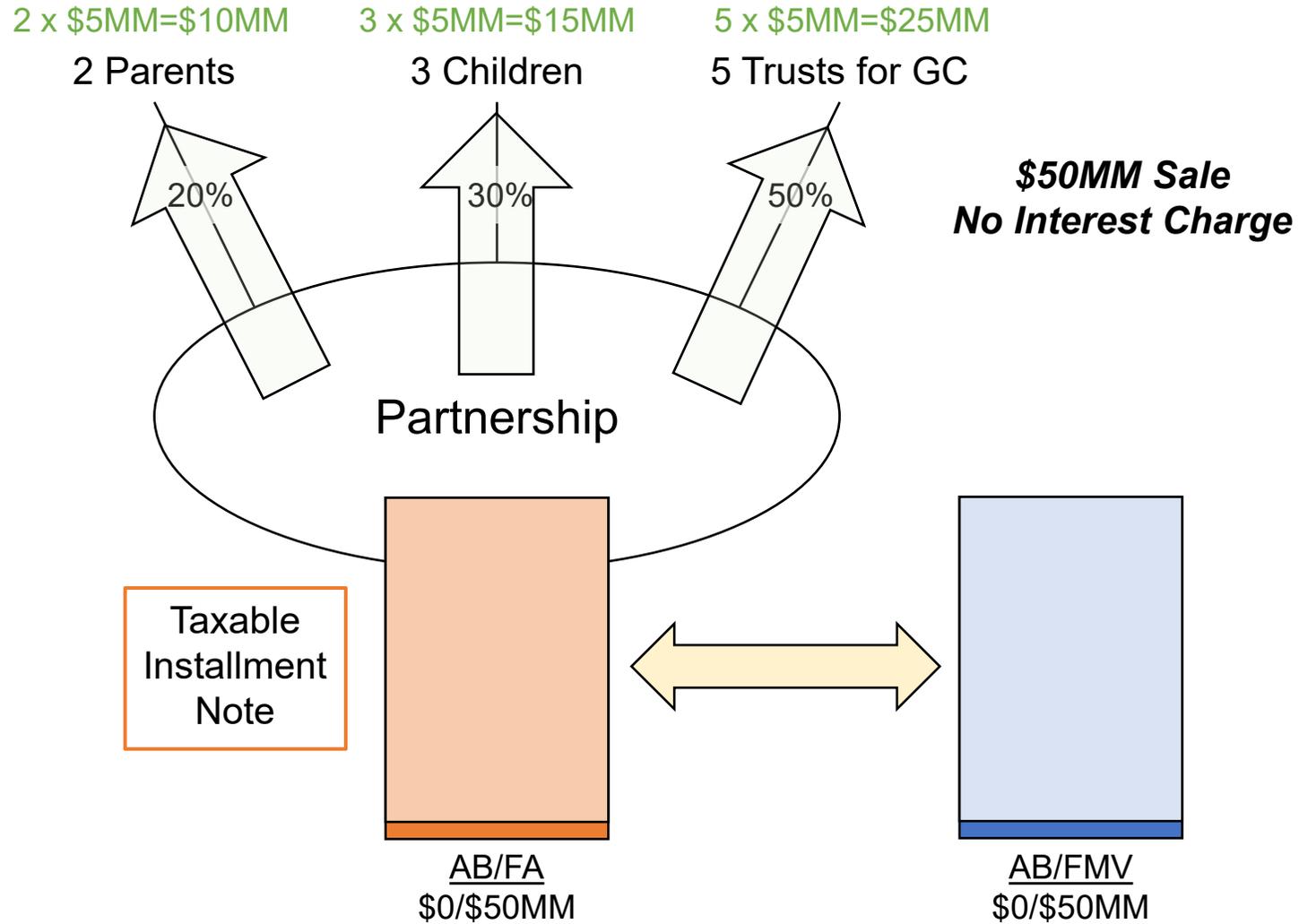


# Refreshing Basis and Resurrecting Depreciation Deductions

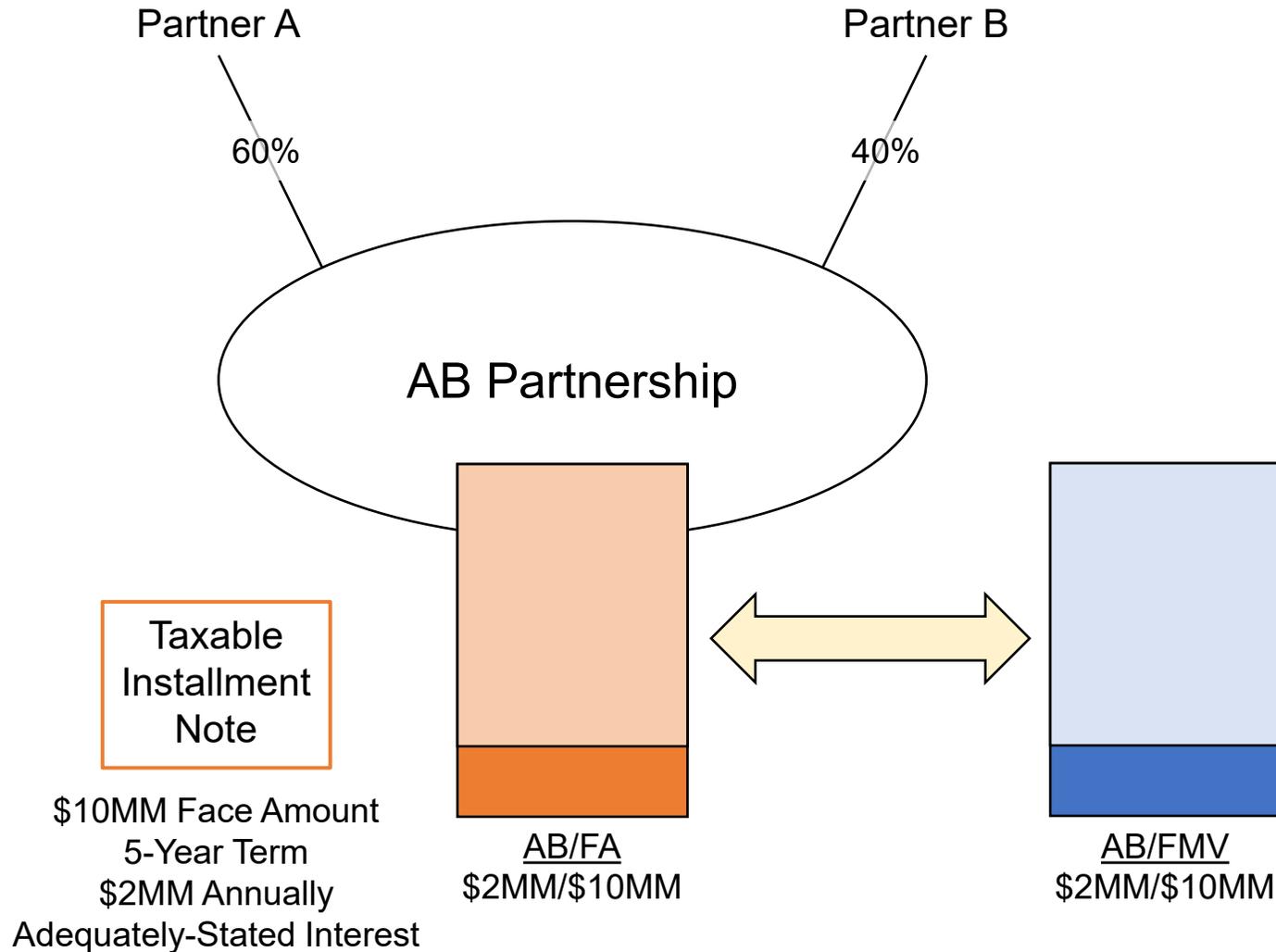


MULTIPLYING THE  
\$5 MILLION THRESHOLD  
WITH A PARTNERSHIP

# Multiplying the \$5 Million Threshold



# Multiplying the \$5 Million Threshold: Allocation of Gain



## Year of Sale (\$10MM Face Amount Outstanding)

- A will be subject to the Interest Charge
- \$6MM of face amount allocable to A (60%)
  - Applicable Percentage = 16.67% (\$1MM/\$6MM)

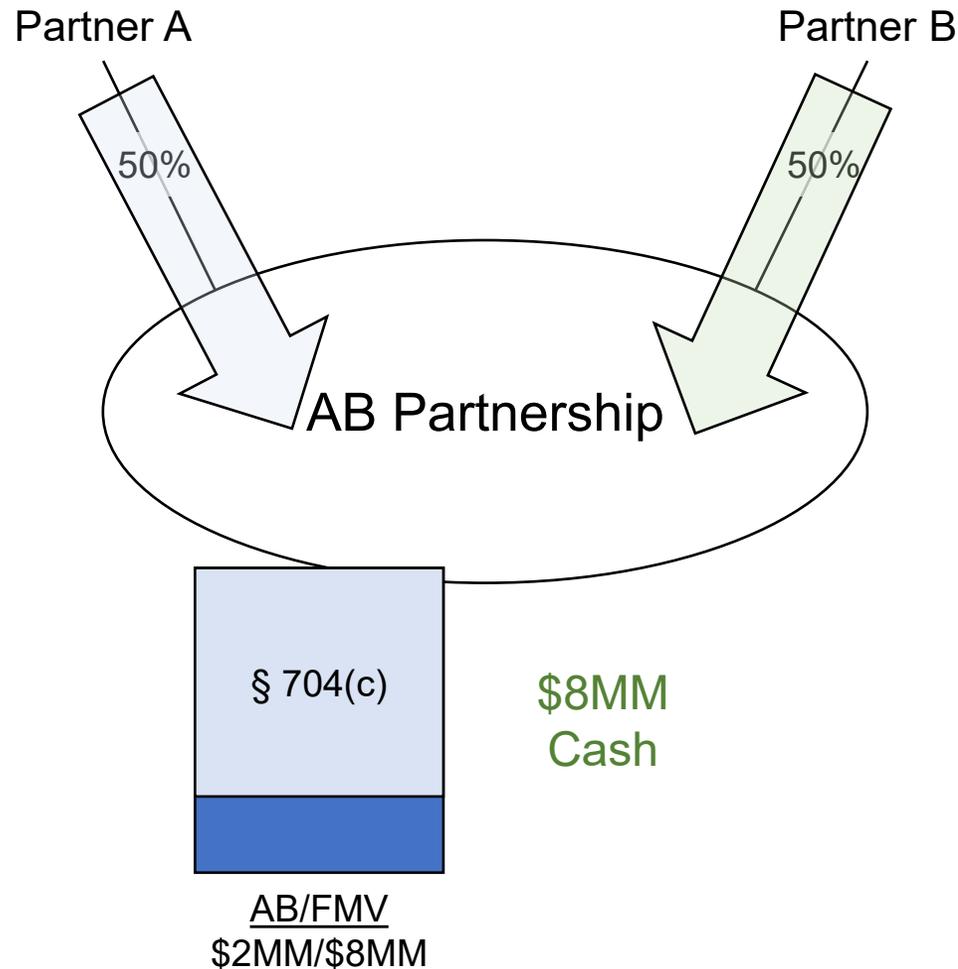
- B will NOT be subject to the Interest Charge
- \$4MM of face amount allocable to B (40%)

## End of Year 1 (\$8MM Face Amount Outstanding)

- A will NOT be subject to the Interest Charge
- \$4.8MM of face amount allocable to A (60%)

- B will NOT be subject to the Interest Charge
- \$3.2MM of face amount allocable to B (40%)

# Multiplying the \$5 Million Threshold: § 704(c) Property

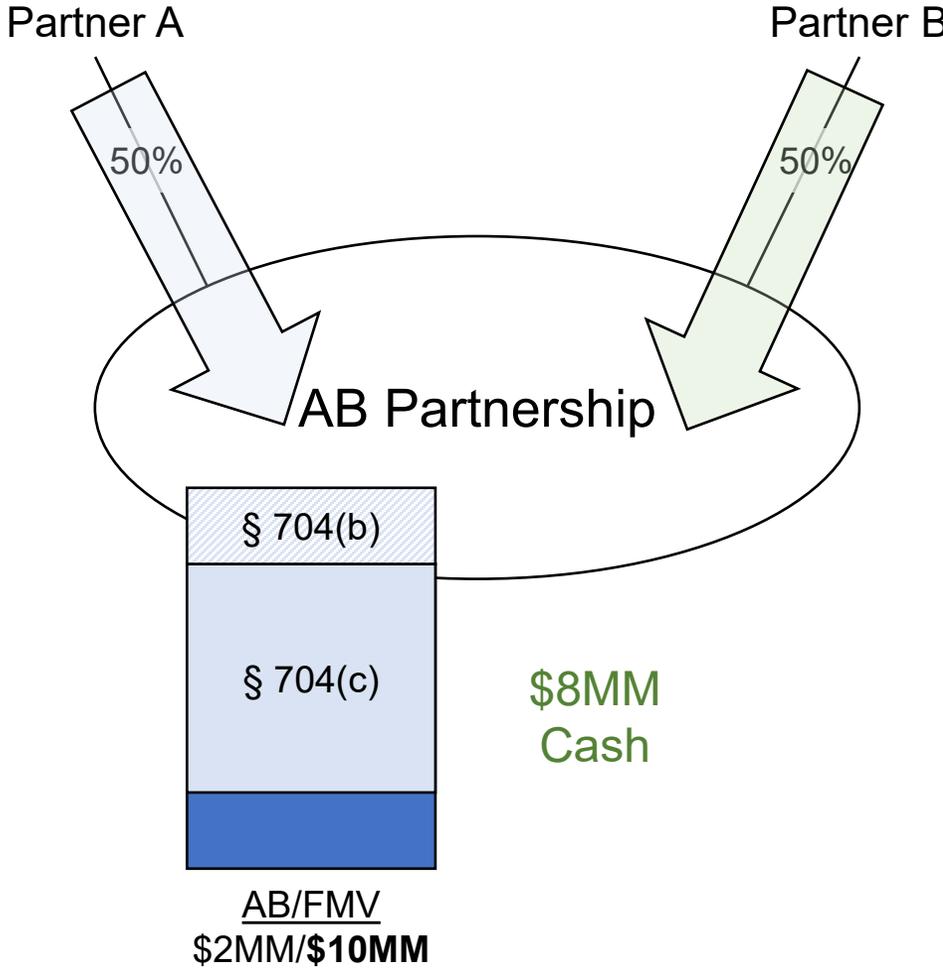


A and B form AB Partnership as equal partners.

A contributes property with a basis of \$2MM and a fair market value of \$8MM.

B contributes \$8MM of cash.

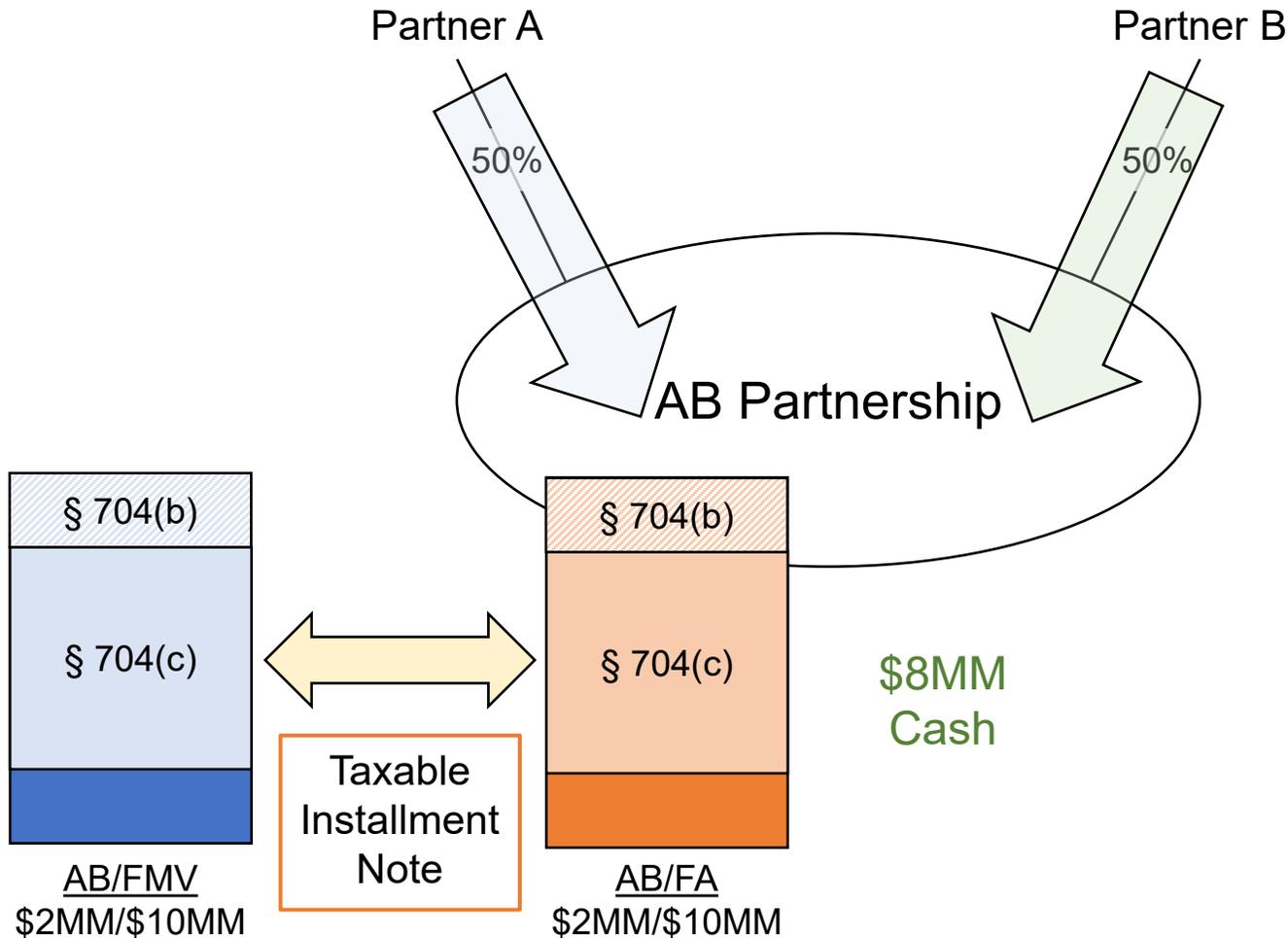
# Multiplying the \$5 Million Threshold: § 704(c) Property



The property appreciates to \$10MM in value.

AB Partnership sells the property in exchange for a Taxable Installment Note.

# Multiplying the \$5 Million Threshold: § 704(c) Property



Treas. Reg. § 1.704-3(a)(8)(ii)

## Year of Sale (\$10MM Face Amount Outstanding)

### A will be subject to the Interest Charge (Option 1)

- \$6MM of gain will be allocated to A under § 704(c)
- An additional \$1MM of gain will be allocated to A under § 704(b)
- A is allocated 87.5% (\$7MM/\$8MM) of the face amount (\$8,750,000)
- Applicable Percentage is 42.9% (\$3.75MM/\$8.75MM)

### A will be subject to the Interest Charge (Option 2)

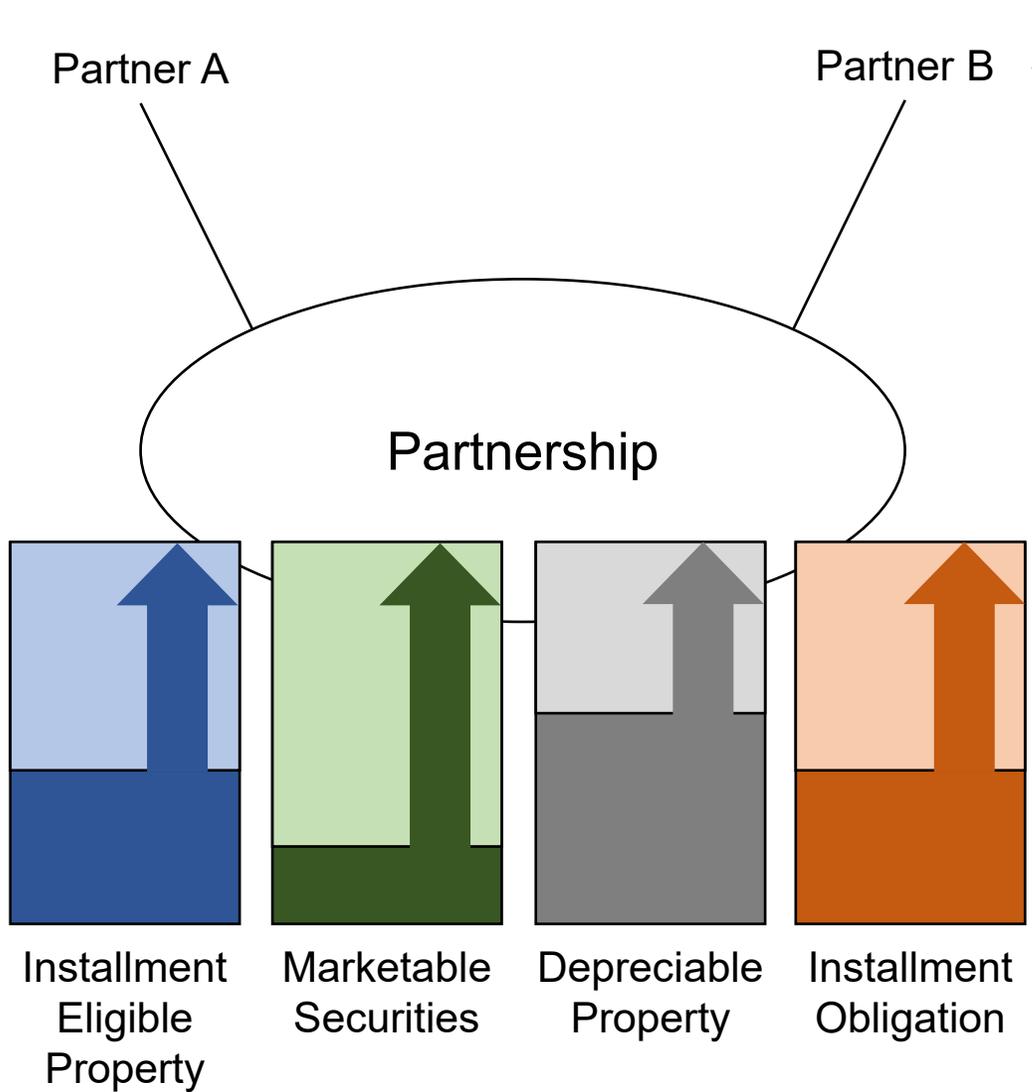
- \$8MM of the obligation is considered § 704(c) property which must be allocated to A
- An additional \$1MM of the face amount is allocated to A (50% of remainder of the face amount)
- A is allocated 90% (\$9MM/\$10MM) of the face amount (\$9,000,000)
- Applicable Percentage is 44.4% (\$4MM/\$9MM)

### B will NOT be subject to the Interest Charge

- \$1.25MM or \$1MM of the face amount is allocable to B

PARTNERSHIP INTEREST  
INSTALLMENT SALES AND  
INSIDE BASIS ADJUSTMENTS

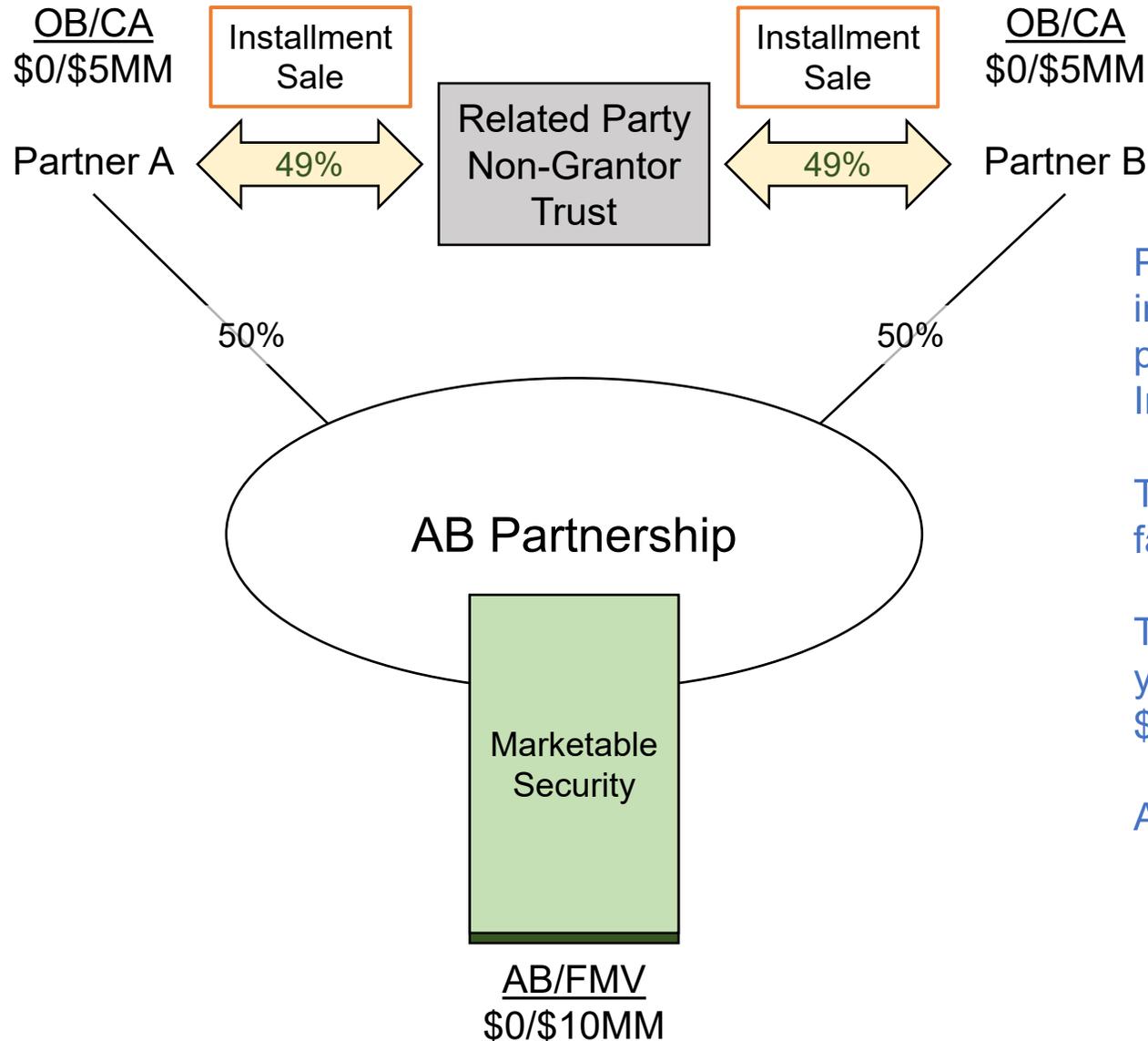
# Partnerships and Sales of Partnership Interests



With some exceptions (i.e., inventory, unrealized receivables, installment notes), the IRS has not treated the installment sale of a partnership interest as a sale of a proportionate sale of the assets of the partnership

- Under what circumstances can an interest in a partnership be sold in installments when the partnership owns assets that are not eligible for the installment method?
- If a section 754 election is in place and an inside basis adjustment increases the basis of the partnership assets, what happens when a partnership asset is subsequently sold?
- What if the subsequent sale occurs within 2 years of the partnership sale?
- What if the installment obligation was contributed and subsequently distributed?

# Marketable Security Partnership: Likely Does NOT Work



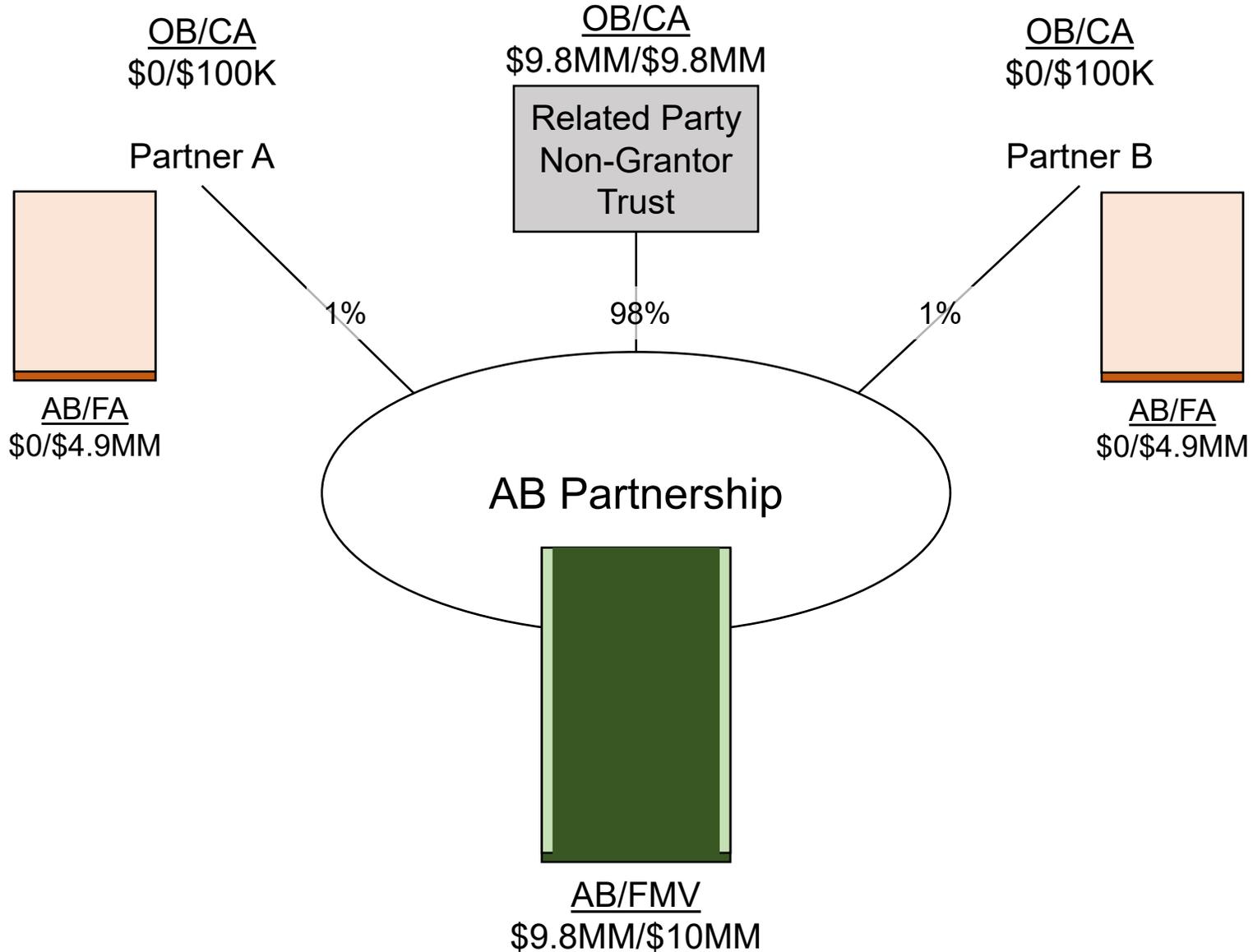
Partner A and B (spouses) each sell a 49% interest in AB Partnership (98% in aggregate) to a related party non-grantor trust in exchange for 2 Taxable Installment Obligations.

The Taxable Installment Obligations each have a face amount of \$4.9MM (\$9.8MM in aggregate).

The obligations provide for interest only for 10 years, followed by 10 equal annual installments of \$490,000 (\$980,000 in aggregate).

AB Partnership has a § 754 election in place.

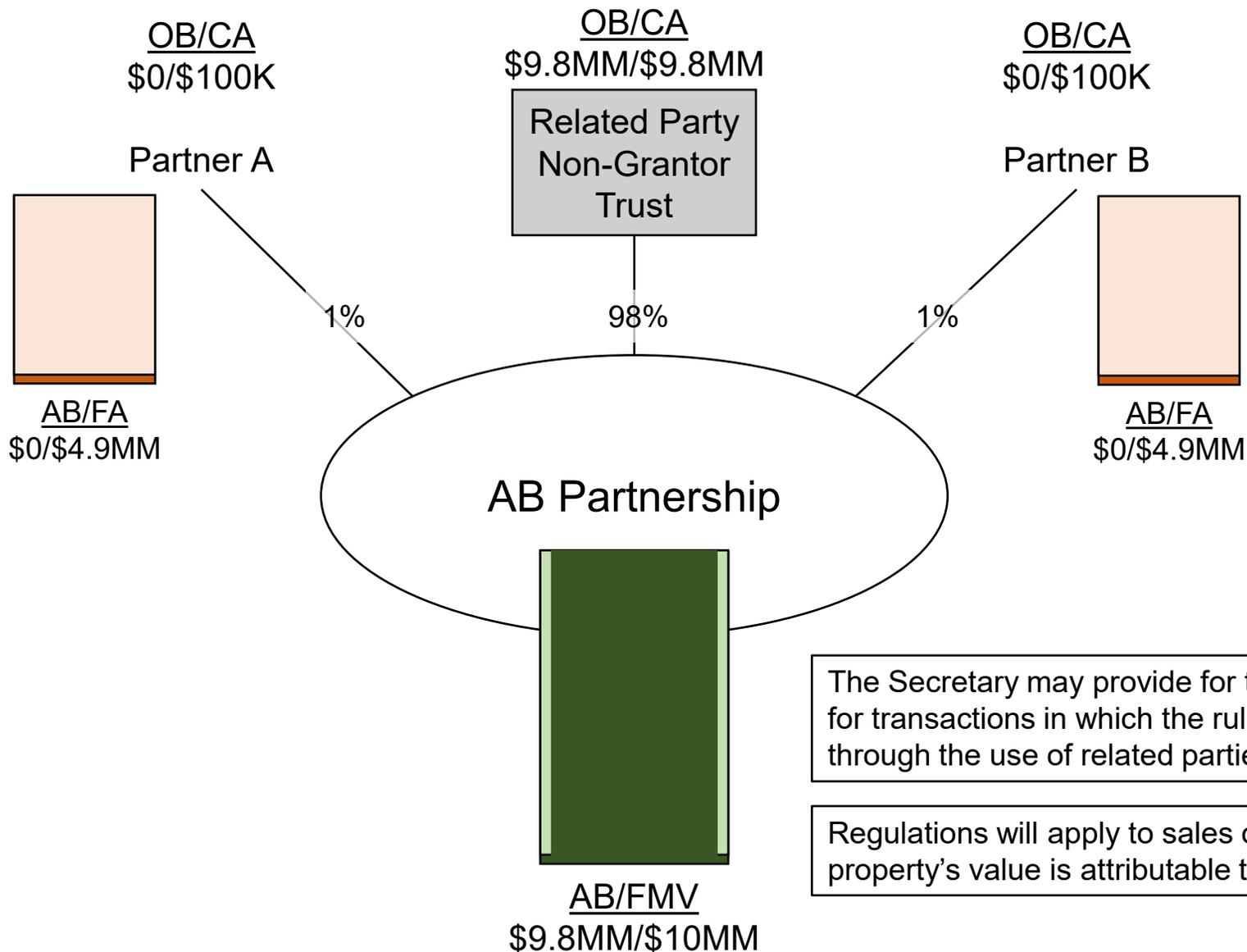
# Marketable Security Partnership: Likely Does NOT Work



Under § 743(b), the inside basis of the marketable security is increased to \$9.8MM.

AB Partnership sells the marketable security.

# Marketable Security Partnership: Likely Does NOT Work



## Taxpayers hope for the following results:

- \$9.8MM of outside basis for the trust
- \$9.8MM of inside basis adjustment
- \$200K of capital gain upon sale of the marketable security
- No Interest Charge payable
- No claim that a related party had made a resale within 2 years
- Long-term deferral of the capital gain

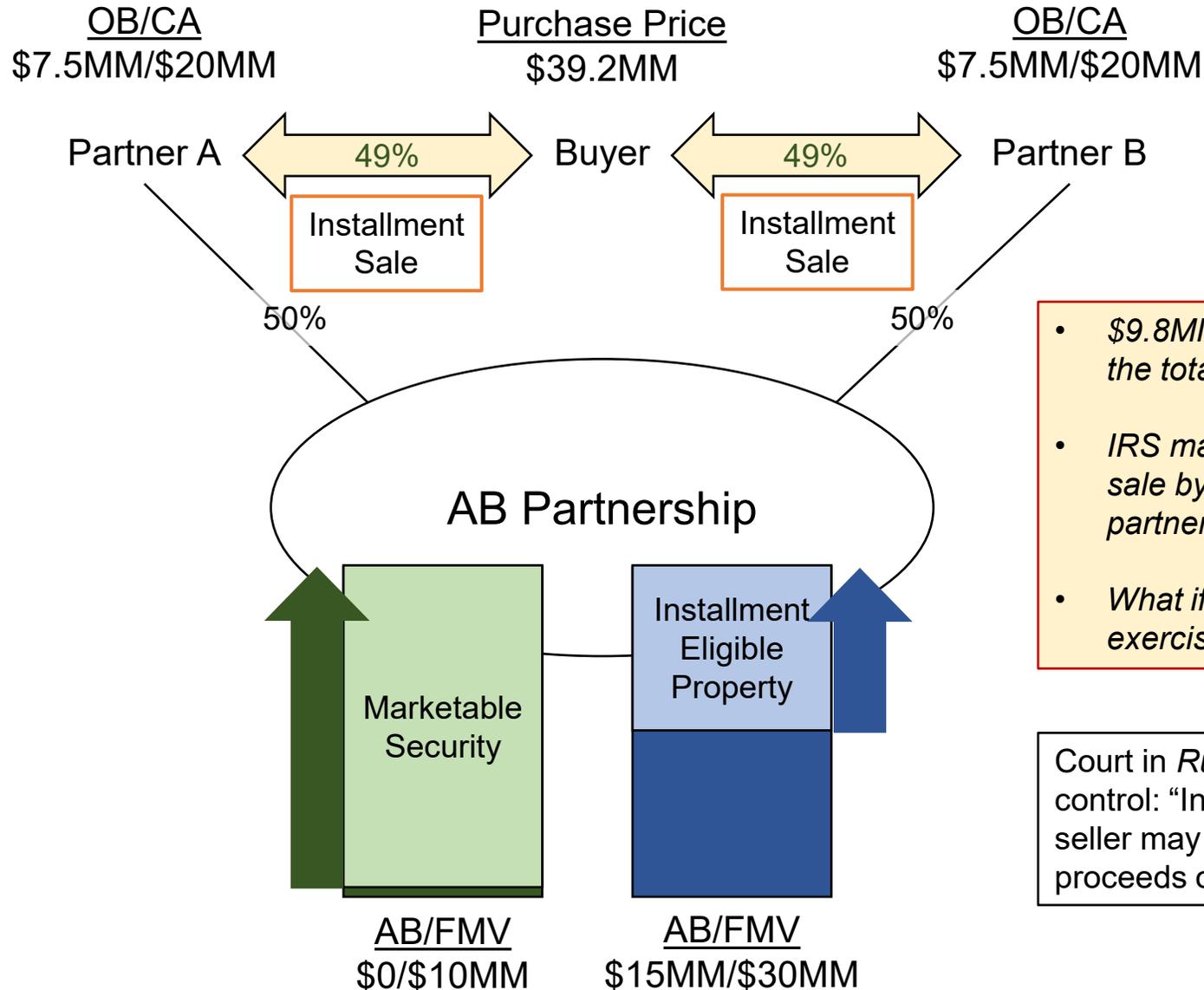
## Actual likely results:

- A and B will recognize \$9.8MM of gain upon the sale of their partnership interests
- No installment sale treatment
- Inside basis of the marketable security will be increased to \$9.8MM under § 743(b)

The Secretary may provide for the application of this subsection in whole or in part for transactions in which the rules of this subsection otherwise would be avoided through the use of related parties, pass-thru entities, or intermediaries. § 453(k)

Regulations will apply to sales of property where a “**substantial portion**” of the property’s value is attributable to gain from publicly traded property. S. Rep. 99-133

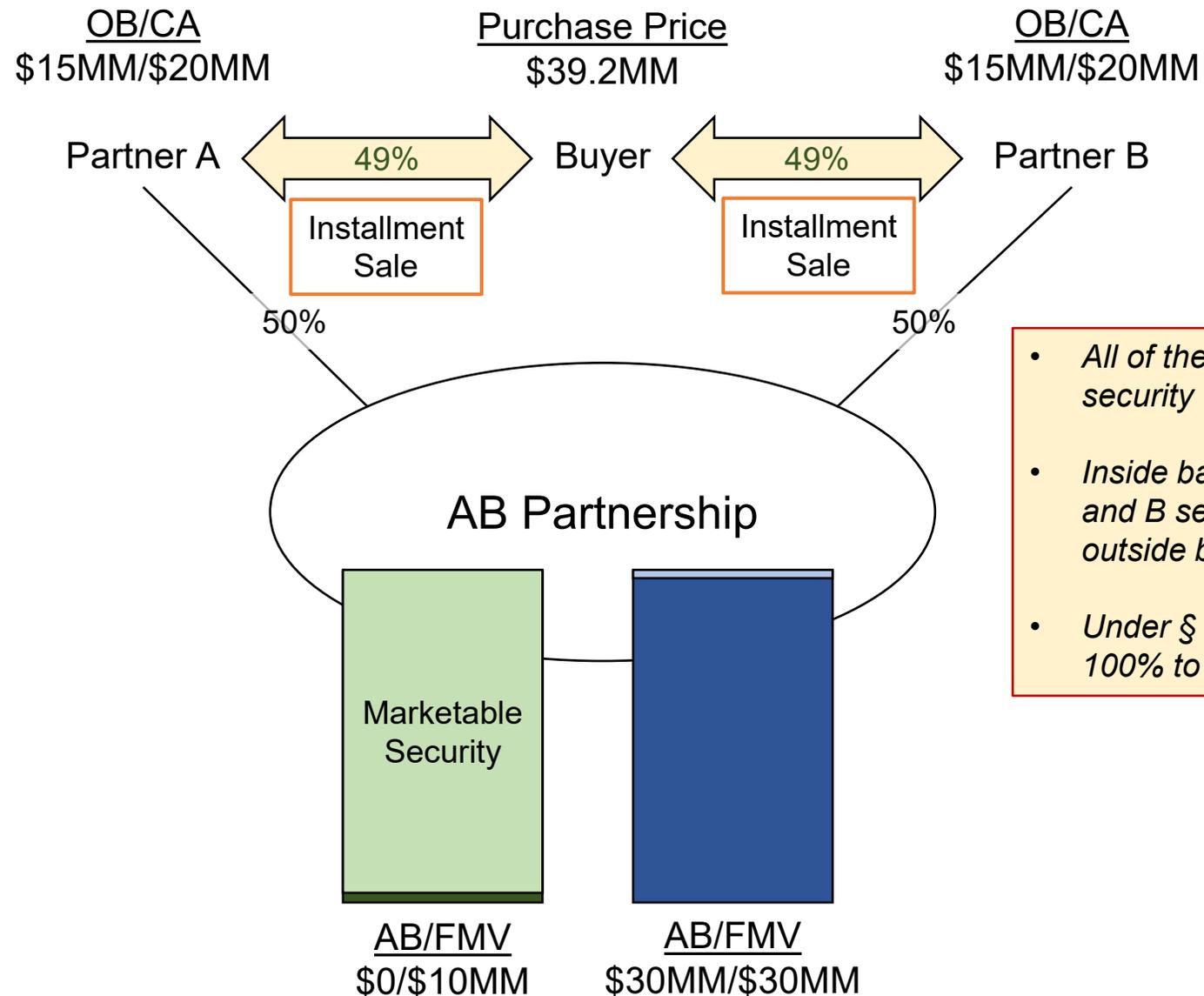
# An Example of What Likely Would Work



- \$9.8MM of appreciation is likely not a “substantial portion” of the total value of the partnership interest sold (\$39.2MM).
- IRS may argue that the sale of the marketable security is a sale by a related party, but what if the buyer of the partnership interest is not a related party?
- What if the marketable security is purchased due to an exercise of a call option by a third party?

Court in *Rushing v. Commissioner* opined the key element is control: “In order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom.”

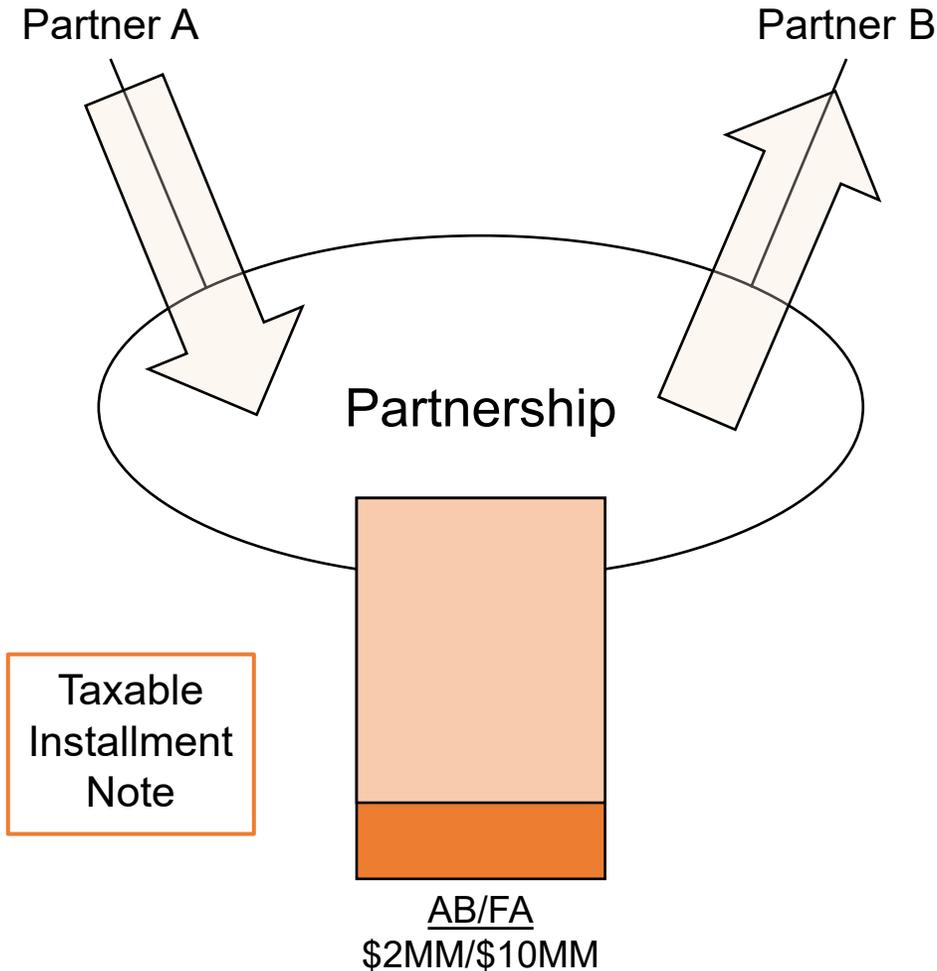
# What About This Variation?



- All of the unrealized appreciation is due to the marketable security
- Inside basis adjustment under § 743(b) will be \$9.8MM (A and B sell in aggregate 98% of AB Partnership with an outside basis of \$29.4MM for a purchase price of \$39.2MM)
- Under § 755, the \$9.8MM basis adjustment will be allocated 100% to the marketable security

# CONTRIBUTIONS TO AND DISTRIBUTIONS FROM PARTNERSHIPS

# Contributions and Distributions of Installment Obligations



Nonrecognition of gain or loss on a contribution of property in exchange for a partnership interest

“Hot Assets”  
Distributions attributable to unrealized receivables or inventory items

The following are not taxable dispositions under § 453B:

- Contributions to a partnership under section 721; and
- Distributions by a partnership to a partner under section 731 (except as provided by sections 704(c)(1)(B), 736, 737, and 751(b)).

“Mixing Bowl”  
Contributed property distributed to another partner within 7 years of contribution

“Mixing Bowl”  
Other property distributed to a contributing partner within 7 years of contribution

Payments to a retiring partner or a deceased partner’s successor in interest

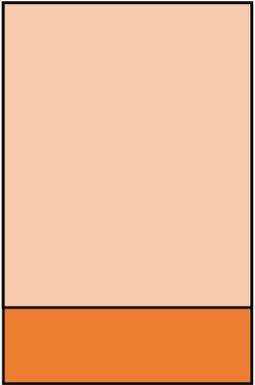
# Distribution of a Partnership Installment Obligation

OB/CA  
\$6MM/\$15MM  
Partner A

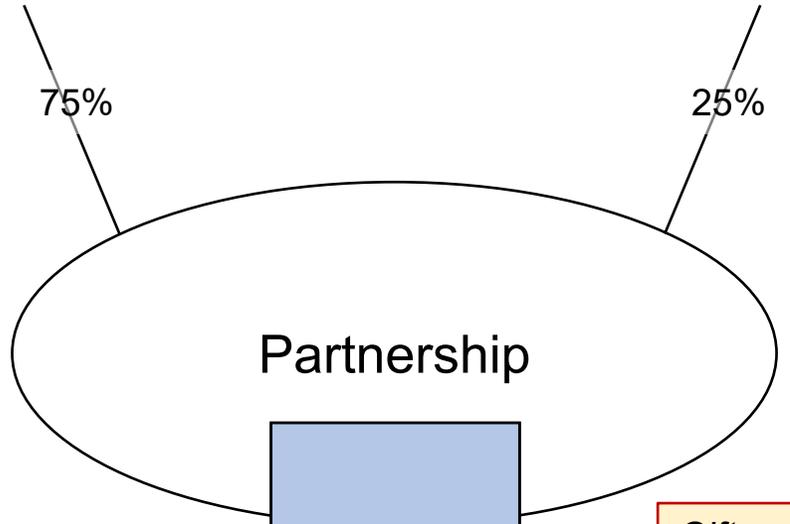
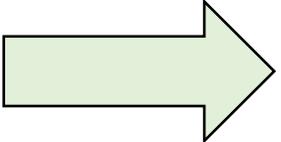
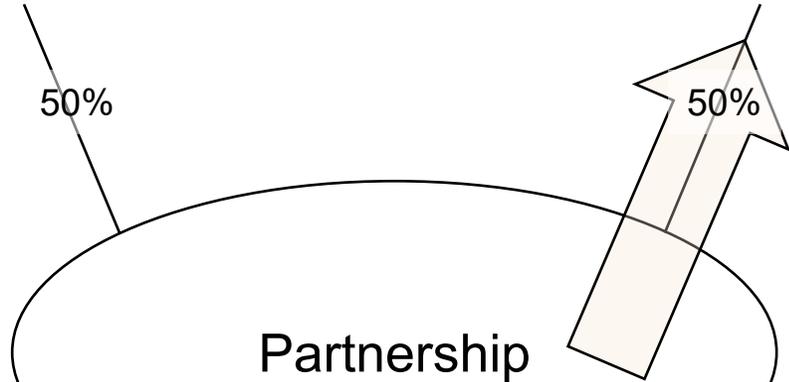
OB/CA  
\$6MM/\$15MM  
Partner B

OB/CA  
\$6MM/\$15MM  
Partner A

OB/CA  
\$4MM/\$5MM  
Partner B



AB/FA  
\$2MM/\$10MM



AB/FMV  
\$10MM/\$20MM

AB/FA  
\$2MM/\$10MM

AB/FMV  
\$10MM/\$20MM

*Gift or sale of an interest in a partnership that holds a Taxable Installment Obligation is considered a taxable disposition of the transferor's share of the obligation.*

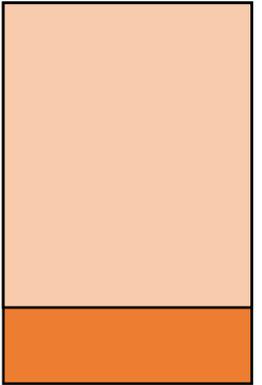
# Distribution of Contributed Installment Obligation: 7 Year

OB/CA  
\$6MM/\$15MM  
Partner A

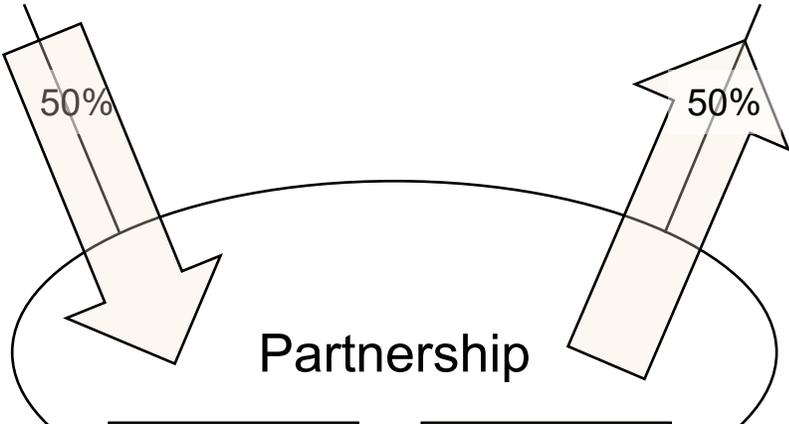
OB/CA  
\$6MM/\$15MM  
Partner B

OB/CA  
\$6MM/\$15MM  
Partner A

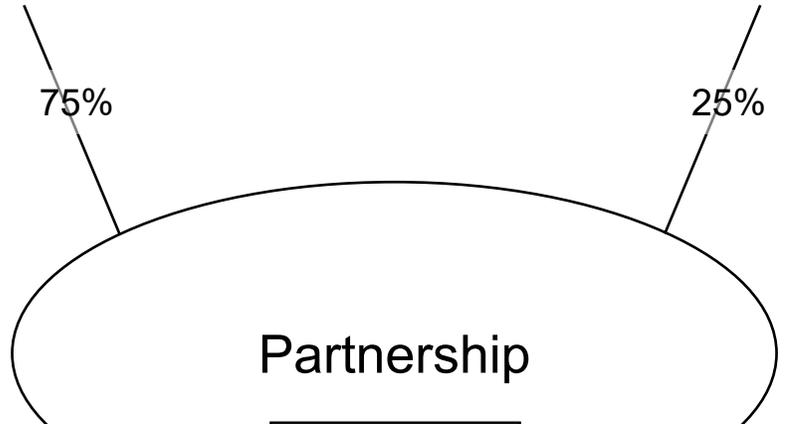
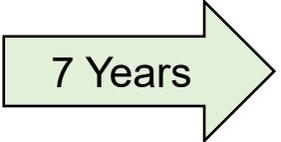
OB/CA  
\$4MM/\$5MM  
Partner B



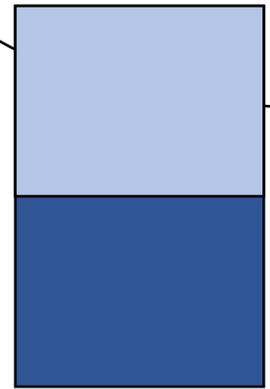
AB/FA  
\$2MM/\$10MM



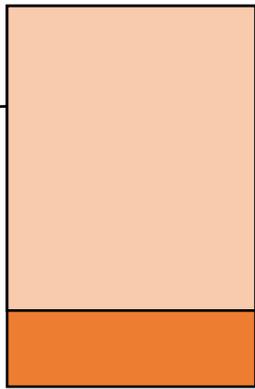
Partnership



Partnership

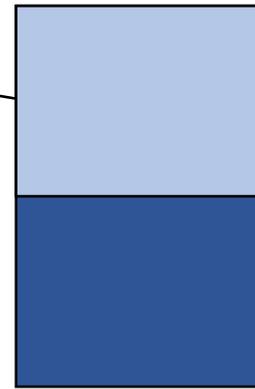


AB/FMV  
\$10MM/\$20MM



AB/FA  
\$2MM/\$10MM

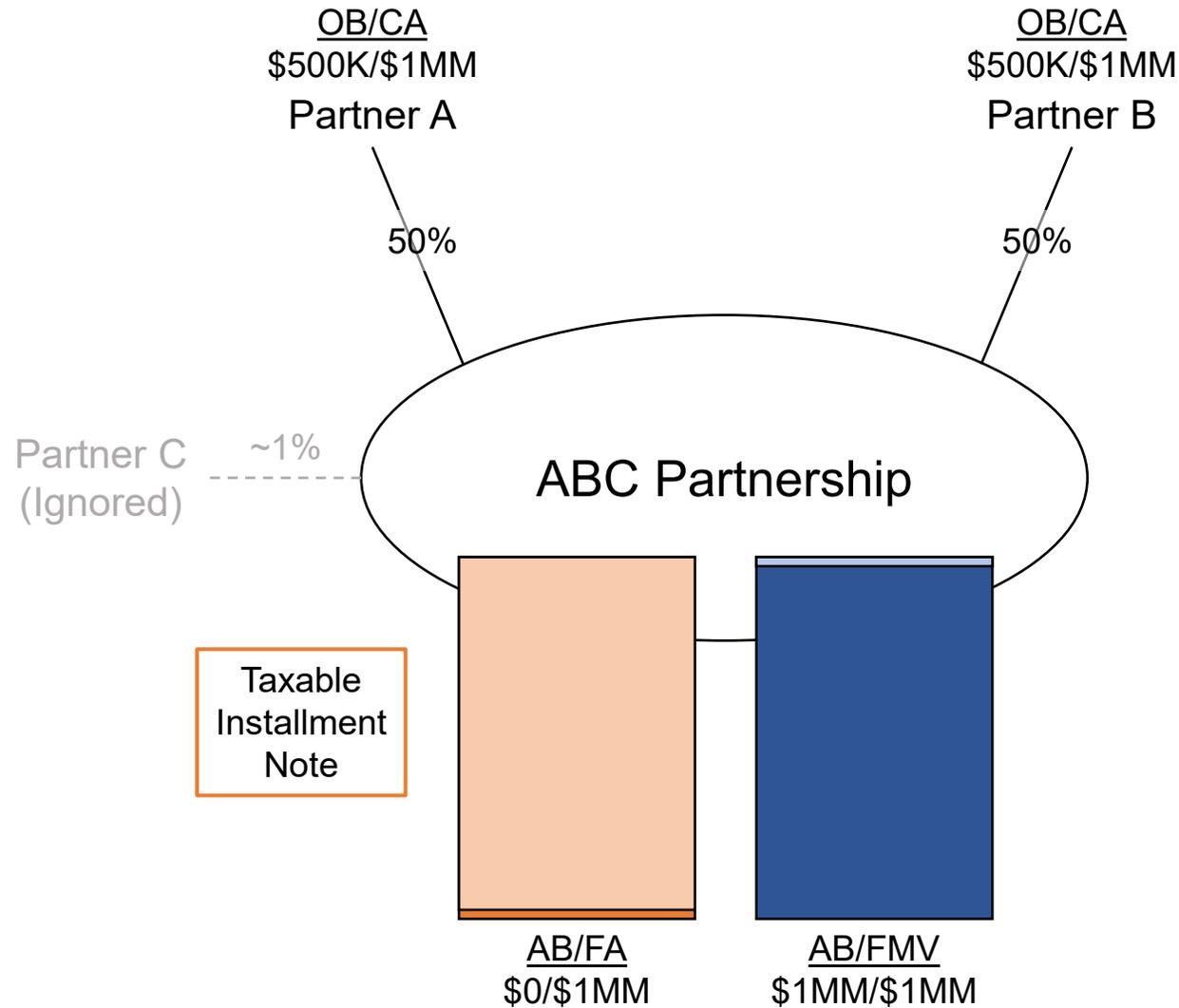
Taxable  
Installment  
Note



AB/FMV  
\$10MM/\$20MM

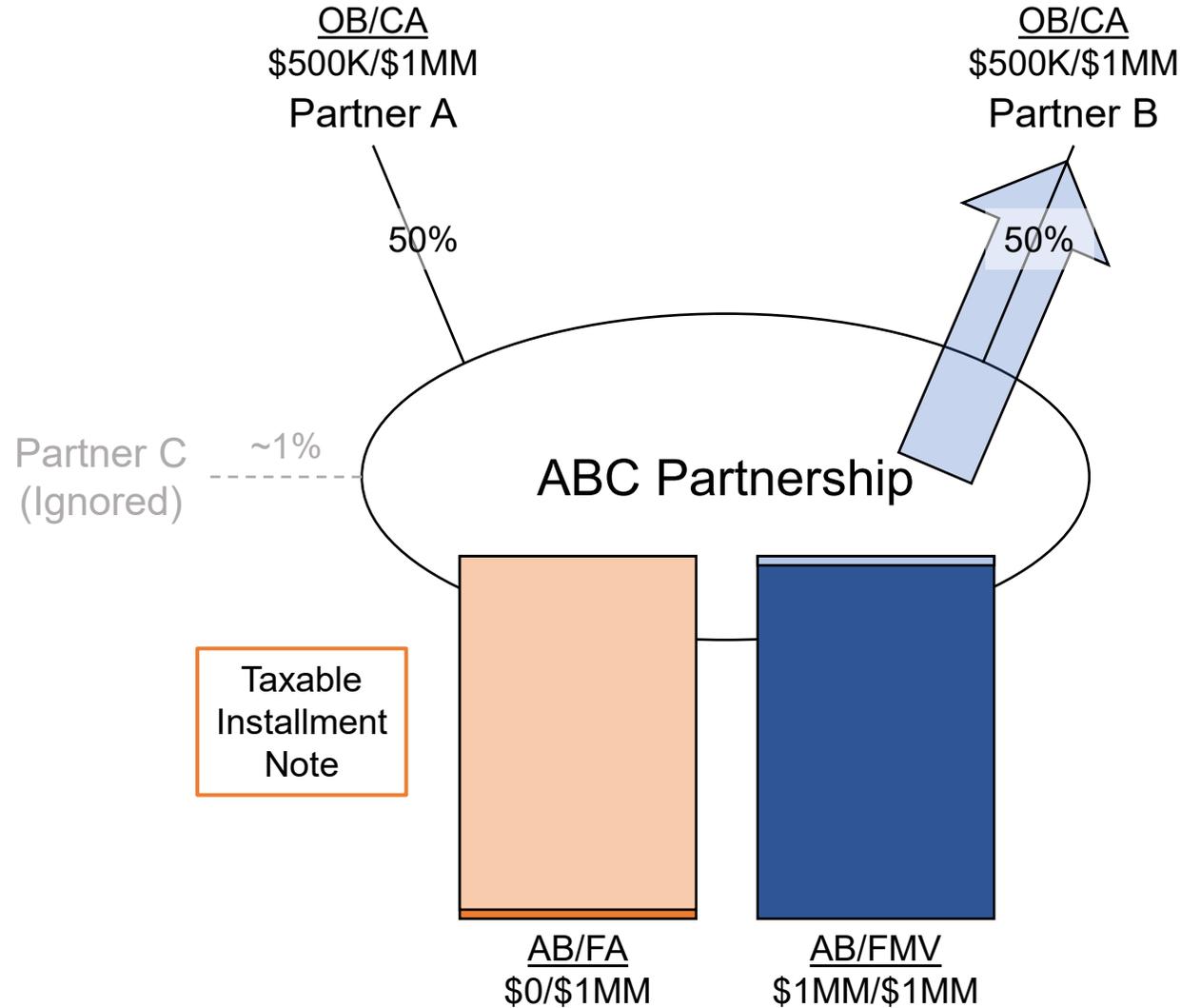
SHIFTING BASIS  
TO  
INSTALLMENT OBLIGATIONS

# Basis Shifting to an Installment Obligation

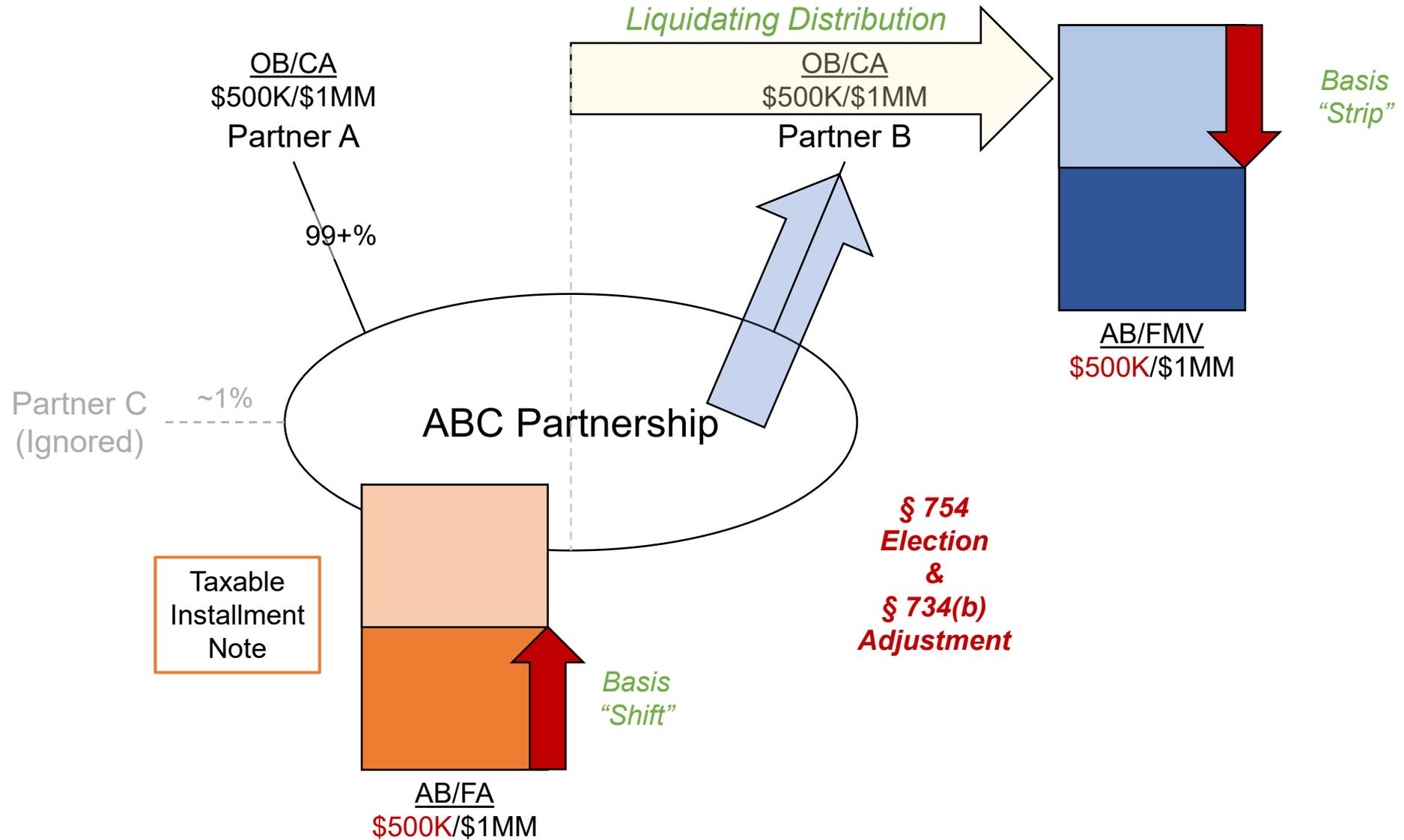


- Assets:
- Purchased by the partnership, or
  - Contributed more than 7 years ago.

# Basis Shifting to an Installment Obligation



# Basis Shifting to an Installment Obligation



# Disclosures

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