Mark to Market freezes - Freeze planning in an estate tax-free environment

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In the wake of the 2016 Presidential election and the unexpected November Surprise election of Donald J. Trump, who has indicated an intention to repeal the 'death tax,' the estate planning community is trying to digest exactly what a repeal of the estate tax would look like, its implications on the practice and, of course, planning opportunities that may arise as a consequence. While one may initially be tempted to conclude that a repeal would have a chilling effect on planning, given the President Elect's proposal to replace the estate tax with a mark-to-market capital gains tax at death for estates exceeding $10 million, a substantial tax bite at death could still occur, albeit at a lower rate (the President Elect has proposed retaining the current 20% capital gains rate). However, in the case of very large estates, a 20% mark-to-market tax at death could still present significant liquidity challenges. This newsletter explores various applications of traditional estate planning 'freeze' transactions that will likely still play an important role in an estate tax free environment, with a new focus on freezing value and/or basis for income tax purposes rather than estate tax purposes.

Admittedly, many of us in the estate planning community were caught a little (a lot) off guard on election night (as was much of the country), when Donald J. Trump clinched the necessary electoral votes to win the keys to the White House. While the President Elect's website has for months described his plan to repeal the 'death tax' and replace it with a mark-to-market capital gains tax at death for estates above $10 million, not a lot of attention was paid to this possibility by the estate planning community at large. Indeed, just five days before the election, Steve Akers, John Porter and one of the authors gave a 'Current Events' presentation at the American Law Institute in Dallas, and it did not occur to them to discuss (more than in a quick passing comment) the possibility of the repeal of the estate tax under a Trump administration. At the time, it simply wasn't something that people were at all focused on. A lot can happen in the course of a week, or more appropriately, in one day.

So here we are, trying to make sense of a whole new dynamic, with a Republican controlled House, Senate and White House, all of whom have expressed support for an outright repeal of the estate tax. [i] A repeal of the estate tax could have far reaching implications, not only for estate planning attorneys, but also for private bankers, financial planners, valuation professionals, accountants and life insurance professionals. The exact contours of these implications are yet unknown, and much of this will depend upon if, how and when any changes to the transfer tax laws occur. Presumably, there are many more pressing issues on the President Elect's 'to do' list, including the stated repeal of Obamacare (although he appears to have softened on this stance post-election), building infrastructure, addressing immigration issues and fortifying our military in the ongoing defense against terrorism. Without a doubt, these initiatives will prove expensive and the new administration will have to find a mechanism to pay for them or incur tremendous additional national debt. So, while it is easy in this period of uncertainty to get tunnel vision about when the repeal of the estate tax may happen, practitioners should keep in mind that, as with all things in Washington, it may take some time.

In the meantime, what follows are some preliminary (and admittedly speculative) thoughts on implications of a possible repeal on the estate planning practice. Change often means opportunity and this could certainty be the case with an estate tax repeal. President Elect Trump's proposal would be to repeal the 'death tax' and to replace it with a mark-to-market capital gains tax at death for estates over $10 million; his plan is silent as to whether gift tax and GST tax repeal would also be on the table and whether and to what extent conforming changes may be made to the income tax law. The House Blueprint calls for a repeal of the estate tax and the GST tax, but makes no mention of repeal of the gift tax.

The Trump Proposal: Repeal of Estate Tax (the 'Death Tax') with Deemed Capital Gains at Death for Estates over $10 million

Trump's plan would essentially adopt a Canadian-style approach, replacing the 'death tax' with a mark-to-market event at death triggering capital gains. This tax would be imposed at a rate of 20%, with a repeal of the 3.8% net investment income tax. While the new mark-to-market tax would technically constitute a capital gains tax at death, rather than an estate tax, practically, it would represent a reduction in the estate tax rate to 20% (on a fully appreciated asset) and a near doubling of the current exemption amount. In other words, under the Trump plan, there would still be a 'death tax' insofar as a tax would be triggered by one's death, it just wouldn't be called that. As Mr. Trump has demonstrated over the past months, branding can be a powerful tool in shaping public opinion.

From a planning perspective, while a 20% hit on gains may be more palatable to clients than the current 40% estate tax on value, and while the $10 million exemption represents a significant increase to the current $5.45 million estate tax exemption, in the case of the client with a net worth of $50 to $100 million, or say $1 billion, a 20% mark-to-market event at death would still result in a significant 'death tax' and could cause a liquidity crisis. Thus, many of the traditional estate 'freeze' planning techniques implemented by estate planners to perhaps discount the current value of assets and shift future growth to more tax efficient 'buckets' (for instance, multigenerational dynasty trusts or preferred partnerships) will very likely remain relevant to the mark-to-market regime under the Trump proposal. Moreover, having such vehicles in place in advance of a possible repeal of the estate tax could pay dividends down the road by providing a platform for future planning and possibly opening doors to creative structures in a post-repeal world.

As a basic demonstration of this point, planning to shift the future appreciation of an asset that parent owns to his or her children will still be important so as to contain the value of the asset in parent's estate, thereby reducing the parent's exposure to the mark-to-market capital gains tax at death. This type of planning may very well involve similar 'freeze' techniques to those currently used by estate planners. If the mark-to-market tax would also apply in the case of a gift, as is the case under the Canadian system, techniques such as sales to grantor trusts would likely still be utilized to accomplish a fair market exchange and shift of possible future growth without triggering a current gift or income tax.

Valuation. Under the Trump proposal, the concept of valuation discounts will still be very relevant to the extent that there exists some form of the $10 million exemption from the mark-to-market tax under the Trump proposal. If, for example, parent dies owning a 50% interest in an LLC that owns a $25 million property, will that LLC interest be worth $12.5 million undiscounted, and therefore subject to capital gains tax on the $2.5 excess, or will the 50% interest be worth less than $10 million after the application of traditional valuation discounts, and therefore not subject to the mark-to-market tax? Query also whether a final version of the Treasury Department's Proposed Regulations under Section 2704 (or a new similar provision) would be applicable or relevant under such a regime. Indeed, because this tax would be an income tax, it might be that the mark-to-market death tax could incorporate additional limitations on valuation discounts without some of the Constitutional concerns implicated by a wealth transfer tax.

Grantor Trusts. The Trump proposal is silent as to whether the repeal of the 'death tax' will be accompanied by conforming changes to federal income tax law. As such, it is unknown whether the mark-to-market tax will also presumably capture assets held by grantor trusts but that are no longer actually owned by the grantor. One could imagine the IRS closely examining trust instruments and administrative records at death to determine whether trust assets should be subject to the mark-to-market tax. Therefore, perhaps an increasingly important component of pre-mortem planning will involve reviewing trust records and taking protective steps to 'toggle off' grantor trust status before death, being sensitive to and planning to avoid the various gain recognition provisions that can apply upon termination of grantor trust status. Trust reporting and disclosure will also likely be an important strategic matter for estate planners to consider in a post-repeal world.

Whittle Down Value, Build Up Basis. Perhaps the new mark-to-market system will present opportunities that are more advantageous than those available under current law. For instance, if the mark-to-market tax will apply based upon the excess of the fair market value of a decedent's asset at death over his or her tax basis in the asset (in contrast to the estate tax, which is imposed solely upon the fair market value of the asset at death), such would incentivize planning strategies to both build-up basis and reduce fair market value. For instance, if parent holds a piece of real property with a very low basis due to years of depreciation and contributes it to an LLC in exchange for non-voting interests, and child or another family member contributes cash or high basis property to the LLC in exchange for voting interests, after a period of 7 years, the child's LLC interest could be redeemed in full or partial liquidation through an in kind distribution of the low-basis property. Perhaps the asset remaining in the LLC would be an insurance policy on parent's life. Section 101 would presumably override the mark-to-market tax on the life insurance proceeds. Moreover, at parent's death, to the extent that he or she only owns a non-voting LLC interest, that interest would likely be entitled to a discount based upon traditional valuation principles, and therefore the mark-to-market tax should be based upon that discounted value. Note, however, that having the LLC own both life insurance and non-life insurance assets could potentially trigger the application of the split dollar insurance regulations under either Treas. Reg. §§ 1.61-22 or 1.7872-15.

Enhancing Outside Basis in Partnership Interests. Consider a family limited partnership that may hold depreciated real estate or low basis securities. As discussed above, the mark-to-market tax will presumably be imposed on the difference between a decedent's outside basis in his or her partnership interest and that interest's fair market value. As a component of pre-mortem planning, estate planners in a post-repeal world may wish to consider using creative debt allocations to increase the outside basis of senior-generation family members.[ii] In the alternative, perhaps the senior-generation family member could issue a personal guaranty of partnership-level debt, thereby increasing his or her outside basis in the partnership interest and reducing the mark to market tax.[iii] In effect, this type of planning would simply invert the current estate planning paradigm, in which planners currently attempt to place low basis assets in the hands of senior-generation family members.

Using Multiple Grantor Trusts. Although likely not feasible under the current gift tax regime, after a repeal of both the estate and gift tax, perhaps parent and child could each fund a grantor trust. Parent's trust could be funded with low basis property and child's trust with high basis property. After a period of time, perhaps the two trusts could be merged to reduce administrative costs, and the grantors could each retain a swap power over the resulting trust. Under the current Treasury Regulations, the trustee of the resulting trust may allocate tax items between the two grantors in any manner that is 'reasonable in light of all of the circumstances.' [iv] These allocations presumably do not need to have substantial economic effect, as is the case with partnership allocations, although there is little authority as regards 'reasonable' allocations in this context. Moreover, after some period of time, perhaps parent could exercise his or her swap power to reacquire the high basis property contributed by the child and substitute additional low basis property, thereby potentially shifting low basis assets out of parent's estate and limiting the potential hit of the mark-to-market death tax.

Dynasty Trusts to Avoid Mark-to-Market Tax for Future Generations. Multigenerational dynasty trusts are currently effective vehicles to preserve assets by applying one's GST exemption to shield trust property from transfer tax for multiple generations. Under a mark-to-market regime, the same type of approach may likely apply for multigenerational mark-to-market efficiency planning. For instance, if parent passes an asset to child at death (after paying the mark-to-market capital gains tax), child will ultimately have his or her own mark-to-market event at death in the future to the extent of any appreciation that occurs during the child's lifetime. If, instead, the parent passes that asset at death, or perhaps during lifetime via a gift and/or sale transaction, to a trust of which the child is merely a beneficiary, presumably the deemed capital gains tax would not apply at the death of the child or at the deaths of more remote descendants. In this regard, a client who has funded a dynasty trust prior to the estate tax repeal using his or her lifetime credit would have a powerful platform to engage in post-repeal estate freeze transactions.

The Fate of Section 1014. Assuming the estate tax repeal does not carry with it a repeal or restriction on the basis step-up provisions of Section 1014, the current estate planning paradigm for clients with a net worth below the applicable exclusion amount would remain in place. For such clients, and even for more wealthy clients, a comprehensive pre-mortem evaluation of assets would be undertaken to ensure the client can receive a basis step-up on the full $10 million mark-to-market exclusion amount. If necessary, swap powers could be exercised or grantor trust status could be triggered in whole or in part to ensure the client dies owning low basis property eligible for a basis step-up. In this regard, the $10 million exclusion would represent a doubling of the current income tax benefit provided to high net worth individuals by Section 1014, essentially allowing them to remove $10 million of appreciation from the federal tax system at each generational level (even before taking into account to the President Elect's proposed exclusion for 'small businesses and family farms').

If there is no step-up in basis under Section 1014 for the first $10 million of asset value, simply no deemed sale (so basis is carried over from the decedent), valuation discounts may be irrelevant. Indeed, if the estate is below $10 million and Section 1014 remains in place, valuation discounts could be damaging. Managing the potential application of such discounts could become an important component of pre-mortem planning. In any case, the new system would presumably have to provide detailed rules to address which assets in an estate in excess of $10 million escape the mark-to-market death tax and which do not.

The Trump Proposal: Considerations If Gift Tax Is Not Repealed

The current proposal from the President Elect is silent as to whether or not the federal gift tax will be repealed. Traditionally, the thought behind not repealing the gift tax along with the repeal of the estate tax was to provide a 'back stop' to prevent income tax shifting. For instance, if in a no gift tax environment, parent decides to gift $5 million to his or her child so that the income generated will be taxed in child's lower tax bracket, no gift tax would be caused by the transfer and an implied understanding could allow the parent to take back the asset when they feel like it with no gift tax to the child. Additionally, if there is no estate tax, then the 'bad facts' implications that would currently be an estate tax concern under Section 2036 would be a non-factor.[v] The retention of some form of the gift tax would also protect the proposed mark-to-market capital gains tax, as deathbed gifting could otherwise circumvent the tax entirely.

If the gift tax is not included in a proposed repeal of the estate tax, then much of the planning implemented will still require navigating the gift tax minefield to ensure no unexpected gift is triggered under traditional gift tax principles, as well as under the Chapter 14 special valuation rules. For instance, if parent wanted to sell interests in an LLC that he/she expects to appreciate in the future (and ultimately be subject to the 20% mark-to-market tax at death), a valuation of the fair market value of those interests would still need to be determined. If the gift tax remains in place and the appraised value of the interests is determined to be lower than the finally determined gift tax value, then there would still be the same type of part sale/part gift issues that planners contend with today. Thus, the same approaches to managing the gift and/or sale of hard to value assets (such as interests in a closely held entity), such as defined value, formula and price adjustment clauses would still remain an integral part of the estate planning practice.

In addition to traditional gift tax valuation issues, if the gift tax were to remain in place, presumably the special valuation rules under Chapter 14 would still exist and the unique gift tax pitfalls thereunder would still need to be carefully navigated to avoid triggering deemed gifts. For instance, the deemed gifts that can occur under Section 2701 when dealing with traditional transfers, capital contributions or changes in the capital structure of a family controlled entity would still present challenges when structuring preferred partnerships, profits interests or carried interest transfer transactions. Similarly, the deemed gift provisions under Section 2702 would still presumably apply with respect to the creation of trusts with retained interests, joint purchases and sales of remainder interests. Lapses of interests under Section 2702 and Applicable Restrictions under Section 2704 could also still remain relevant if the gift tax is not repealed. Lastly, the Proposed Treasury Regulations under Sections 2704 and 2701 (if finalized) could remain relevant under a continued gift tax regime.

The Trump Proposal: Considerations If Gift Tax Is Repealed

If the proposed repeal of the estate tax ultimately includes the repeal of the gift tax, the planning implications and opportunities presented are different, but are certainly present. If the gift tax becomes history, then such would provide an opportunity for creative planning that would enable clients to, in a sense, reshuffle the deck with respect to trusts and other entities in a manner they would prefer but perhaps cannot do under current law. Without the constraints of traditional gift tax rules and the special valuation rules under Chapter 14, great flexibility in planning will be afforded. This is even more the case if a gift tax repeal and the House Blueprint, which calls for the repeal of the estate and GST taxes without the imposition of a mark-to-market capital gains tax at death, were to become law. Under such a regime, clients would have maximum flexibility to modify existing family planning and governance structures to fulfill tax and non-tax objectives.

For instance, bargain sales of interests or perhaps outright gifts could be made by parent to reduce their estates below the $10 million mark-to-market threshold. Perhaps this could be achieved by way of a transfer into a trust with parent retaining the right to access to that trust, either as a beneficiary or through withdrawal rights. Without a gift tax and the rules of Sections 2701 or 2702, such could be a way to simply remove the asset from the parent's hands for mark-to-market purposes, while at the same time enabling the parent to have access to the asset. Further, in an estate tax free world, the retention of such 'strings' would be irrelevant and would enable parents to engage in planning that would provide a 'have your cake and eat it too' arrangement that is simply not possible under the regime that exists today. This would allow clients to arrange their family structures in a way that retains the significant non-tax advantages afforded by current estate planning techniques (organized governance, creditor protection, business succession, etc.), while optimizing current income tax efficiency and providing generous access and administrative control to family members.

Without the gift tax, various family entities and arrangements could be structured freely as the family would wish to on an 'on the merits' or 'rough justice' kind of approach, without having to tip toe through the current Section 2701 minefield that provides significant challenges. For instance, a manager of a private equity fund could simply make a gift of his or her general partner interest (with the carried interest) to his or her child gift tax-free and without the current 'vertical slice' requirement (or application other non-vertical approaches). Or perhaps a real estate developer could simply give a child a profits interest in a new deal without gift tax issues under Section 2701 or traditional theories. In this manner, substantial future appreciation could be transferred to such child or better yet to a trust for child's benefit, and perhaps parent's benefit too (since there would be no longer be any 'retained strings' estate tax implications under Section 2036).

Another lingering uncertainty is what will come of the GST tax. While the Trump proposal is silent as to the GST tax, the House Blueprint explicitly calls for its repeal. A repeal of the GST tax could present opportunities to reduce administrative complexity and make other helpful modifications to family trust structures. Consider, for example, a disposition at death that directs GST exempt and GST non-exempt property to separate trusts that are otherwise identical. A repeal of the GST tax would perhaps allow the merger or other consolidation of the two trusts, thereby reducing administrative costs and complexity and streamlining family planning structures. Additional modifications may also be possible after the repeal of the GST tax, including extending the perpetuities period of an existing trust or modifying a grandfathered trust that may otherwise lose such status under the current GST tax regime.

Of course, a repeal is only as 'permanent' as the attitudes and preferences of the next Congress. If a repeal of the estate and gift tax does occur, practitioners should keep in mind that the eventual reinstatement of some form of a transfer tax is not beyond the realm of possibility. Granted, it would likely take more political capital to enact a new 'death tax,' rather than merely standing in opposition to the repeal of a current estate tax. However, if a transfer tax system might be reinstated in the future, perhaps in the case of the Democrats winning control of the House and/or Senate in 2018 or a Democratic candidate winning the White House in 2020, then a repeal of the estate, gift and/or GST taxes under a Trump administration could provide a unique opportunity for families to restructure entities, trusts and other arrangements in the most desired manner, free of the restrictions of current law. A subsequent reinstatement of the transfer tax system would enable families to plan in advance to get the various pieces of family structures in place well in advance of any new transfer tax system.

Moreover, recall that there was no proposed repeal of the gift tax under President George W. Bush's 2001 Tax Act, which included a repeal (albeit delayed) of the estate tax. The gift tax protects the integrity of the income tax system in large measure, such as by preventing loss property owned by one family member from being 'married up' with gain property owned by another.

While the landscape for estate planning may be changing under a Trump administration, with change comes opportunity, and freeze planning will continue to be an important arrow in the planner's quiver.

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_[i] For an excellent discussion of the planning implications of the 2016 election, see Jim Magner's webex, The 2016 Election Results Are In: How Will this Impact Us in 2017 and Beyond? (Nov 11, 2016).

[ii] Section 722 and Treas. Reg. § 1.752-1(b).

[iii] See generally Treas. Reg. § 1.752-2(b).

[iv] Treas. Reg. § 1.671-3(a)(2).

[v] For a recent example of 'bad facts' under Section 2036, see Estate of Beyer v. Comm'r, T.C. Memo 2016-183.

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