Facing change: Current United States tax and estate planning ideas

11 AUGUST 2020

CATEGORY:
ARTICLE

CLIENT TYPES:
FAMILY BUSINESSES

HIGH-NET-WORTH INDIVIDUALS

FAMILIES AND FAMILY OFFICES

TRUSTEES, EXECUTORS AND FIDUCIARIES

At just past its midpoint, 2020 has certainly been an unpredictable year. The relentless shocks to our routines and expectations do, however, present a number of important and timely estate, gift and income tax planning opportunities. Uncertainty at a political level, and the possibility of further changes in the tax code, create urgency.

1. Gifting

A federal estate tax of 40% is due on taxpayer's estates at death (if married, it is due on the death of the surviving spouse) if the estate(s) exceed the then available exemption amount. An available exemption amount is excluded from taxation, which amount can either be gifted during life or bequeathed at death with no gift or estate tax due. As between married persons, any unused portion of the available exemption amount can be carried over to a surviving spouse, or "ported," to be added to their available exemption amount and is then later available for that person to use. For 2020, the current exemption amount is $11.58 million per person, annualized for inflation, thus increasing each year, until it drops back down in 2026. As a result, in 2026, the exemption amount will drop to $5 million, adjusted for inflation, which when indexed for inflation is expected to be approximately $5.5 million.

Proposed regulations which came out in November 2018, clarify that the IRS will not seek to claw back (or disallow) amounts gifted prior to the exemption amount being reduced in 2026. Importantly, the proposed regulations allow taxpayers to rely on this no claw back provision.

With uncertainty as to whether the November election could lead to a political power shift and a possible reduction in the gift and estate tax exemption amount, clients should consider gifting their full exemption amount. Additionally, in California, we have seen recurrent attempts to impose a California estate tax, though no measure is on the November ballot. While not successful to date, imposition of a California estate tax could happen in the future.

Given state and federal budgetary shortfalls arising from the COVID-19 crisis and general deficit spending, we see ongoing pressure to raise taxes on the wealthy. Further, presidential hopeful Joe Biden, aims to lower the exemption amount to $3.5 million if he is elected as set forth in his recent tax plans. Therefore, clients who can afford to gift should consider doing so since the ability to gift at these levels may not exist much longer. Obviously, no one should gift more than they are comfortable gifting or that they can afford.

2. Planning for the full sale or majority interest in a private company

Succession planning is a key milestone in a company's lifecycle and should be done proactively, not reactively. As a result of the pandemic's impact, as well as the natural lifecycle of businesses generally, many founders and other owners will decide to sell all or part of their business in the coming years for a variety of reasons.

The opportunities for a successful valuation and outcome for a business sale remain high. While valuations are down in 2020 across a wide variety of sectors, other areas of the economy are booming. Investment capital remains at high levels and buyers are looking to invest in private companies – distressed or soaring.

Importantly, those planning the eventual sale of a business (a capital asset), Joe Biden's recent tax plan aims to get rid of preferential tax rates on capital gains and dividends, increasing the maximum federal rate to 39.6% on capital gains (and dividends). Thus, for those company owners undecided about the timing of selling their business, the potential for a near doubling of the capital gains tax could be a deciding factor.

3. Sale of capital assets

Capital assets as a group extend well beyond the interest in an active business, including such diverse categories as art works, collectibles and certain intellectual property rights. The current maximum federal tax rate on the sale of most capital assets is 20% plus the 3.8% Medicare tax. As above, Joe Biden's tax proposal will end the preferential capital gains rate and will tax capital gains and dividends at 39.6%. Those individuals contemplating such a sale should consider accelerating their timing to benefit from the current capital gains tax rate should substantial change at the government level seem likely.

4. Utilizing the low interest rate environment to maximize long term estate planning

Certain irrevocable trust structures allow for maximizing gifts to beneficiaries, and the current low interest environment makes such planning even more advantageous. Grantor retainer annuity trusts ("GRATs") and intentionally defective grantor trusts ("IDGTs") are two such options.

A GRAT is an irrevocable trust in which a grantor exchanges assets for the right to receive fixed payments (annuity) at least annually, based on the original fair market value of the property contributed to the trust. At the end of a specified time period, any remaining assets pass to the beneficiaries identified in the GRAT, either outright or in trust. The determination of assets passing on depends on the assets growth but also the IRS assumptions built into the GRAT structure. When contributing assets to a GRAT, the IRS assumes that they will grow at a fixed annual rate. This rate (known as the Section 7520 rate) varies month to month. For August 2020, it is 0.4%, an all time low. Because the IRS assumes the assets will grow at this rate, it is often referenced as a "hurdle." An asset that is likely to "beat the IRS assumption" by growing faster than the IRS assumes it will can be a good choice for a GRAT.

Since the gift being made is calculated at the inception of the GRAT, it is potentially beneficial because if the assets contributed grow faster than the IRS assumes the beneficiaries will receive a much larger gift than was required to report. This leverages the estate and gift tax exemption available. Further, a GRAT can be enhanced to be zeroed-out which eliminates any gift tax or use of the grantor's available exemption upon its creation.

An IDGT is an irrevocable trust that allows transfers to the trust to be complete for gift and estate tax purposes. However, the grantor retains certain powers over the trust, such as the power to reacquire trust property for cash or other assets of equal value, causing it to be "defective" for income tax purposes (i.e., any income earned by the trust is taxable to the grantor instead of the trust or its beneficiaries). The grantor either pays gift tax on the transfer or uses up part of their exemption amount. But, the grantor also pays taxes on any income arising from the assets in the trust allowing the trust to grow tax-free, essentially such income tax payments are tax-free gifts, but the assets in IDGT are not included in the estate of the grantor. IDGTs are often structured as part gift, part sale with an initial gift made to the trust by the grantor, and remaining assets are sold to the trust in exchange for a promissory note with interest at the Section 7520 applicable rate dependent on the term of the note. For August 2020, the Section 7520 rates for range from .17% to 1.12%. Like a GRAT, the interest rate on the promissory note is considered the hurdle rate for an IDGT and evaluation of its success, with the appreciation of the assets exceeding the promissory note and the interest passing to the beneficiaries.

5. Charitable planning

Under current law, taxpayers in certain circumstances get a deduction from taxes due based on their charitable contributions made during the year. The amount of that deduction varies based upon the charitable entity receiving the deduction and the form of the contribution.

Under the recently passed CARES Act, individuals (who itemize deductions) can elect to deduct donations up to 100% of their 2020 adjusted gross income (up from 60% previously). Beyond the scope of the CARES Act, the deduction for qualified charitable contributions made by itemizing individual donors is limited to 60% of their adjusted gross income. Corporations can deduct up to 25% of taxable income, up from the previous limit of 10%.

Thus, for those with income to offset with deductions in 2020, making a charitable donation can result in material tax savings. Charitable contributions can be used to reduce a capital gains tax liability by donating long-term appreciated assets. When doing so, the taxpayer can deduct the fair market value of the contribution from their income tax due, while also minimizing the capital gains tax of up to 20 percent.

Charitable trusts that meet certain technical requirements can be established to further benefit from the charitable deduction. In such instance, a qualified charity is designated as the beneficiary of either the income interest, a charitable lead trust ("CLT") or the remainder interest, a charitable remainder trust ("CRT"). The IRS views such trusts as tax-exempt and allows for the growth and income taxes to be deferred, reduced or eliminated while allow the taxpayer to receive a charitable deduction. Again, the tax benefit hinges on the Section 7520 rates and with today's low rates, charitable trusts are a formidable option in planning.

6. Utilizing the 100% depreciation deduction

The Tax Cuts and Jobs Act increased the bonus depreciation percentage from 50 percent to 100 percent for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. This change is applicable to depreciable business assets with a recovery period of 20 years or less and select other property. Machinery, equipment, computers, appliances and furniture generally qualify. Also eligible are film, television, live theatrical productions, and some used qualified property. Taxpayers may elect out of the additional first-year depreciation, and depreciate as otherwise applicable based on the type of asset.

Large purchases that qualify, including private planes for example, make sense if already planned and taxpayers have an income level sufficient for the deduction. When making such a purchase the ongoing costs related to the capital asset purchased must be factored into the decision. And, since the asset has been depreciated to zero, any subsequent sale of that asset will be fully taxable.

7. Reassessing state tax rates and long term residency options

Many states facing budgetary shortfalls due to the fallout from COVID-19 and earlier issues are aiming to increase state tax rates. So, for example, California is proposing an increase at its highest tax rate from 13.3% to 16.8%. Some states are proposing that increases (including California) be retroactive to the beginning of 2020. Thus, taxpayers should review the proposed changes in their state of residence and recognize income when appropriate in 2020 – checking first to ensure that no retroactive proposals are pending.

8. Creating a family limited partnership (or LLC):

A family limited partnership (FLP), or limited liability company (LLC) treated as a partnership for tax purposes, can be an effective tax planning mechanism. This structure is created to hold assets such as real estate, a privately owned business or even a brokerage account. The creator of the FLP can gift interests in the entity, while still retaining control. Essentially, different classes of ownership interests are created, some voting, with others being non-voting. The creator can then gift non-voting interests to children or other beneficiaries, while retaining control of the voting interests. The value of the gift is often discounted from the FLP's underlying asset values, due, e.g., to lack of control (voting and/or ownership) and marketability. Additionally, payments made from the FLP can vary based on ownership type, voting or non-voting, allowing for payments to go to either the creator or the beneficiary. By directing the payments to the beneficiaries, the creator can get more assets out of their estate and often the tax rate applicable to the beneficiaries will be lower than that of the original creator.

9. Updating old documents:

Over time, even well drafted company, partnership or estate planning documents become dated. Circumstances evolve. People are no longer around to fill the roles we expected of them or other people might have grown into their roles. And, tax and other laws do change as well. Updating documents, or at least reviewing them periodically (preferably with a professional) is a crucial step in ensuring that future problems, taxes and other expenses are minimized.

10. Maintain liquidity:

Cash is king, as the old adage goes. With the uncertainty in our economy during this turbulent year, ensuring ample liquidity is an important consideration. The unpredictability which has plagued our year still shows little sign of abating. Many financial institutions are tightening lending and flexibility on payment terms. As a result, all individuals and businesses should ensure that they have enough liquid capital to survive an unexpected catastrophe or further, extended lockdowns.

11. Private placement life insurance (PPLI)

Private placement life insurance is a variable universal life insurance policy that provides cash value appreciation based on a segregated investment account and a life insurance benefit. No federal or state income tax on income or gains inside the policy is due, thus tax free redeployment of assets occurs. The aim of this type of policy is to eliminate income tax on funds invested in this policy, not insure against mortality or create a pool of liquidity. Appreciation in the policy can be borrowed during lifetime with no income tax resulting. The death benefit is exempt from income tax, and the structure allows for investing in foreign funds without penalty. Certain drawbacks are inherent in this structure. Individuals cannot manage the money themselves. Instead, an independent investment manager must be appointed or the funds must be invested in insurance dedicated funds. Additionally, the account must be diversified, with at least five assets held in specified proportions. Any registered investment manager can be hired to manage the account.

All in fees over five to seven years should average around 100 to 125 basis points per year, which includes the carrier administration fee, cost of insurance, agent's commission and amortization of up-front costs.

12. Legislative Retroactivity

There is concern among many that a change in administration could lead to certain federal tax changes being enacted on a retroactive basis by the next congress. The current consensus is that any federal retroactive effective date likely will be no earlier than January 2021.

13. Biden tax proposals:

- **Personal income tax and estate**

Joe Biden has released a tentative tax proposal plan to implement is he is elected President. While not overly detailed, the proposals do give us some very informative insights. The personal income rates will change under the plan, with taxable income above $400,000 taxed at 39.6%. Long term capital gains and qualified dividends will be taxed at 39.6% (plus the 3.8% Medicare tax) if income exceeds $1,000,000. There will no longer be a step-up in basis at death, with possible mark to market taxation of unrealized gains at death also being a possibility. The itemized deduction benefit will be limited to a 28% cap. Meanwhile, the Pease limitations requiring the phase out of itemized deductions are restored for taxable incomes greater than $400,000. The 20% qualified business income deduction will be phased out for taxpayers having taxable income greater than $400,000. As mentioned, the exemption amount will decrease from $11.58M to $3.5M per person (indexed). Significant limits on valuation discounts will be enacted.

- **Social security increases**

The current OASDI (old age, survivors and disability insurance) payroll tax is 12.4% up to a $137,700 wage base. Under Biden's proposed tax plan, the 12.4% OASDI tax would be extended to wages above $400,000. The Medicare tax would remain at 2.9% on all wages, plus 0.9% on wages in excess of $250,000.

- **Corporate taxation**

Joe Biden's plan will increase the corporate income tax rate from 21% to 28%. A new alternative minimum tax of 15% on book profits of $100M or higher is proposed. The tax rate on so called "global intangible low-taxed income" ("GILTI") would effectively increase from 10.5% to 21%. A VAT (value added tax) has been suggested but is not likely.

Conclusion

You should evaluate all applicable planning opportunities and act fast, reaching out to outside advisors when needed. Even if you're not ready to pull the trigger on these options now, being poised to move quickly when we have a better sense of further change will be key. Waiting could make

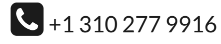
it too late to do any meaningful planning or take important action.

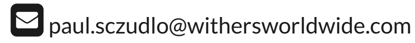
Authors

Paul Sczudlo

OF COUNSEL | LOS ANGELES

Private client and tax

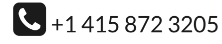

+1 310 277 9916


paul.sczudlo@withersworldwide.com

Genevieve M. Larson

PARTNER | SAN FRANCISCO

Private client and tax

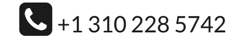

+1 415 872 3205

genevieve.larson@withersworldwide.com

Megan L. Jones

ASSOCIATE | LOS ANGELES

Private client and tax


+1 310 228 5742

megan.jones@withersworldwide.com