

Chess Moves

- Tax Reform and Prospect for Rising Rates
Call for Contingency Planning to **Promote Flexibility**-



This note focuses on two conditions that may substantially impact the wealth of many: (1) how to confront the potential loss of estate tax reduction benefits should interest rates rise, and (2) how to confront recent White House proposals for increased death taxes (both a new capital gains tax and increased estate tax). These conditions have caused us to write this Special Edition in order to highlight certain planning options, that have become available as a result of economic and financial conditions and also recent IRS rulings approving unique strategies. For those with taxable estates, we have previously written about the advantages low interest rates provide, and whether the Federal Reserve's desire to see those rates rise will soon be successful. Our recent focus has been on locking-in these historically low rates to secure the estate tax reduction potential they offer. Furthermore, recent IRS rulings have approved of methods of financing estate taxes at these historically low rates, with that financing provided through a family controlled private foundation while the leverage secured (growth of wealth) inures to the benefit of junior family members. We have also discussed how the current rise in the federal estate tax exemption encourages termination of existing estate planning structures, such as family limited partnerships ("FLPs"), qualified personal residence trusts ("QPRTs"), and other forms of gifting trusts. However, the recent White House proposals mentioned above have complicated the decision making process associated with terminating existing structures.

Terminating Old Structures - What Chess Moves Can be Made to Counter White House Proposals?

First, if your estate is projected to exceed \$5.43 million (\$10.86 million if married), you can move to the next section, as this section only has nominal relevance to you. If you no longer have a projected taxable estate and have created FLPs, QPRTs, or various other types of strategies, including gifting trusts for children and grandchildren, you should read this note because it may be in your families best interest to address termination of these old planning structures. Why?

Saving estate taxes generally is accomplished in one of four ways: (1) by gifting, (2) by manipulating and reducing the value of a taxable estate, such as occurs using a family limited partnership, (3) by intra-family sales, where growth above a threshold level or rate of return is removed from an estate without a gift, and (4) by using certain charitable strategies. When using 1 through 3, the historic cost basis of assets transferred by senior family members to junior family members also transfers to them, resulting in continued exposure to capital gains tax after death.

Current law provides that assets included within a decedent's estate receive a step-up in cost basis to fair market value, eliminating capital gains on which tax is calculated. For example, an asset with an original cost of \$500,000 that is worth \$1 million at death, receives a \$1 million cost basis as it passes to heirs. If that same asset had been gifted during life, the inherent \$500,000 cost basis would transfer to the donees and they would recognize a capital gains tax, potentially exceeding \$100,000 on sale. Since the estate tax is a tax on the value of wealth passing at a current rate of 40% (45% under White House proposal), it often makes sense to sacrifice

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the capital gains tax advantage of a step-up by using one or more of the strategies for estate tax reduction described above. However, that is only the case when an estate tax exists. Because of the rise in the estate tax exemption (currently \$5.43 million), many who undertook advanced estate tax reduction planning no longer have an estate tax exposure, even if the prior planning was terminated. Therefore, they may desire to terminate the old planning so that the property affected receives a step-up in basis and heirs avoid the capital gains tax detriment of prior planning. *Note:* This is explained in greater detail in our Winter 2015 Client Update.

Termination has gotten more complicated given White House proposals. These proposals include two provisions that directly confront this type of planning: (1) a reduction of the estate tax exemption in 2016 from \$5.43 million to \$3.5 million, and (2) elimination of the benefit of a step-up in basis, by requiring recognition of the gain at death. Both an estate tax and capital gains tax would be imposed under these proposals. Furthermore, the capital gains tax would be imposed on a far greater number of decedent's than the estate tax, since the exemption thresholds are much lower. Though these proposals are unlikely to become law, they have stymied decision making.

We are recommending clients consider "contingent terminations," where proper documentation makes termination conditional on an appropriate set of circumstances. For example, termination may be structured to occur immediately before death, but only assuming the assets involved will (1) receive a step-up in basis, (2) will not incur capital gain recognition, as proposed by the White House, and (3) that they will not cause an estate tax, whether or not White House proposals to reduce the estate tax exemption become law. Contingent termination avoids duplication in cost and premature termination, as it would only become effective if positive results occur. Furthermore, many clients who undertook fiscal cliff planning in 2012 have built-in mechanisms to accomplish contingent termination, and we are recommending that these clients and others, who have old strategies in place, consider the benefits of terminating these structures.

Locking-In Historically Low Interest Rates to Reduce Estate Tax and Using Them to Finance Any Residual Tax

A. How Low Interest Rates Can be Used to Shift Wealth Tax Free.

Our current historically low interest rates offer significant estate planning advantages, particularly as planning migrates down a more sophisticated path. As discussed in the above section, there are essentially four ways to confront estate tax: (1) make gifts, (2) manipulate and reduce value, (3) use intrafamily sales, or (4) use certain charitable strategies. This section focuses on the latter two, with a premise that many clients with larger estates have used, and continue to use, their gifting ability and have created family holding companies, many in limited liability company or limited partnership form to reduce value. For example, it is common for families with projected taxable estates to have family partnerships and to have family trusts for children and grandchildren as partners. Often the trusts for children and grandchildren have gained their equity share as a result of gifts, using one or more gifting techniques that consume all or a portion of senior family member estate and gift tax exemption. Gifting shares of properly structured family holding companies consumes less estate and gift tax exemption, as a result of valuation discounts. However, what options are available to a person who no longer has gift tax exemption available or otherwise desires some cash flow from the assets transferred? Sales of discounted shares in exchange for promissory notes bearing acceptably low interest provides a common solution. The advantage occurs as a result of leverage, where the potential total return (income and capital appreciation) on the assets transferred exceed the

stated interest and this excess is levered out of the taxable estate without constituting a gift. What is important to understand by those familiar with the good and bad of investment leverage (losses can be enhanced), properly structured there is no downside because the leverage can be eliminated in a tax and cost free manner due to how these structures are created. In essence, they can be terminated without significant consequences.

For example, if a senior family member in April 2015 sold \$10 million of Pfizer (“PFE”) stock to a grantor trust for junior family members in exchange for a promissory note that was payable in 20 years and bore the lowest interest rate allowed by the Internal Revenue Service (“IRS”) without a gift, the results of leverage would produce the following results without income, gift, or estate tax- the assumption is that PFE maintains its 3.24% dividend and grows at 6% a year- a total return of 9.24% :

PFE Value =	\$ 10,000,000
Total Annual Return	9.24%
Future Value in 20 Years (compounded)	<u>\$ 58,564,418</u>
April 2015 Applicable Long Term Federal Rate	2.47%
Interest Paid Through Maturity (simple)	\$ 4,940,000
Total Paid at Maturity- Note Face Balloons	<u>\$ 10,000,000</u>
Total Paid Through Maturity of Loan	\$ 14,940,000
Total Tax Free Wealth Transfer	\$ 43,654,418

In the above example, assuming the 2.47% of interest paid to the senior family member (\$247,000 per year) is consumed, the tax savings realized by the leverage generated from low interest rates is \$17,461,767. It is also important to note that these transactions are accomplished without the inherent unrealized gain being recognized. This is generally accomplished through the use of so called “grantor” or “intentionally defective trusts,” which are authorized by statute.

Assuming the same facts in the above example, if the PFE or other assets were contained in a family holding company or FLP, the leverage produced and benefits increase as a result of valuation discounts. For example, if shares of an FLP were used, with underlying assets equivalent to the PFE value (with some level of diversity) and the underlying assets generated the same total return (9.24%), as in the above example, the results would be as follows:

PFE Liquidation Value =	\$ 10,000,000
Appraised Valuation Discount	35%
Value of FLP Shares Represented	<u>\$ 6,500,000</u>
Total Annual Return for PFE	9.24%
Future Value in 20 Years (compounded)	<u>\$ 58,564,418</u>
April 2015 Applicable Long Term Federal Rate	2.47%
Interest Paid Through Maturity (simple)	\$ 3,211,000
Total Paid at Maturity	<u>\$ 6,500,000</u>
Total Paid Through Maturity of Loan	\$ 9,211,000
Total Tax Free Wealth Transfer	\$ 49,353,418

When combining the benefits of both valuation discounts and leverage, the results are magnified. The amount of tax free wealth transfer has increased by \$6 million and an additional tax savings of approximately \$2,400,000 is realized. As can be seen through both of these examples, the largest component of the tax free shift to junior family members is driven by leverage- the spread between the cost (interest paid) on capital appreciating at a higher rate. Thus, low interest rates enhance leverage, all things being equal. As mentioned above, it is important to understand that the risks of typical investment leverage do not exist in these intrafamily arrangements and locking-in our historically low rates can produce substantial estate planning benefits.

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There are a variety of ways to enhance the leverage achieved in the above examples that create even greater benefits. Several employ shorter term durations to unfold their results. Planning in this area also necessitates a review of one's present circumstances. Creating these structures involve a number of considerations, including:

- The amount of cash-flow the senior family member desires from the transaction.
- Whether that cash-flow should be secured or unsecured.
- Whether the amount of wealth shifted on an annual basis should be immediately available to children or grandchildren.
- An analysis of the integrity of the projected return, including a review of the fundamental value of the underlying assets. For example, how realistic is the PFE projected return in the above example?
- An understanding of the current yield curves and relationship to the timing of transactions and their duration.

We call this stage of planning, Phase 3 planning. A result of Phase 3 planning can be that senior family members hold much of their wealth in the form of promissory notes (secured or unsecured). Typically, that would leave a senior family member with limited options to avoid estate tax on the notes, as promissory notes in the nature of installment obligations are difficult to transfer in a manner that would accomplish further estate tax reduction. Nevertheless, if unsecured and bearing a low rate of interest, authority exists to reduce their value for estate tax purposes below the face value of the note - a form of valuation manipulation.

B. Financing the Estate Tax at Current Rates: Or, No Tax at All - Checkmate!

What would one say if the estate tax on the promissory notes (left after the above Phase 3 planning had been accomplished) could be deferred or amortized at current rates for over 15 years? What if no tax is paid at all, and what would have been paid in tax is converted to a bequest of the notes to a family controlled private foundation. The results could be that (1) substantial wealth has been transferred to junior family members during life using Phase 2 and 3 strategies, (2) senior family members have frozen their estate from increasing and incurring greater estate tax exposure, (3) what would have been paid to the U.S. government in the form of tax is now controlled by family governance of a private foundation, and (4) the advantage of leverage at our low interest rates is secured through note payments to the foundation over an extended period of time. Is this possible?

The answer is, "yes" and the IRS recently approved of the mechanics needed to accomplish this objective. Often to fully accomplish complete estate tax avoidance, however, an amount in excess of the tax otherwise paid also would need to be transferred to the private foundation. However, assuming leverage is realized at a sufficient level, the deferral can produce results on a present and future value basis that equate to either insignificant or no estate tax. Furthermore, the family controls the wealth for their philanthropic purposes, potentially in perpetuity and for generations to come.

A host of regulations must be confronted when using a private foundation where direct or indirect transactions occur with family members. For those familiar with these rules, they become routine. Though fairly complex compared to Phase 2 and 3 planning, this strategy may be all that is left for some senior family members who have used all other available techniques at their disposal.

We are pleased to offer you these recent developments and planning solutions.



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