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Facing Change: Current Tax and Estate Planning Ideas

Paul Sczudlo and Megan Jones

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INTRODUCTION

- At just past its midpoint, 2020 has certainly been the year of the unpredictable.
- The ongoing shocks to our 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

- An estate tax of 40% is due on all estates at a taxpayer's death (with a spouse it can be due at the second death).
- An exemption amount is excluded from taxation, and that amount can either be gifted during life or bequeathed at death with no tax due.
- The unused balance of the exemption amount can be carried over to a surviving spouse, or "ported" to be used later by that spouse and added to their exemption amount.
- The current exemption amount for 2020 is $11.58 million, an amount which is annualized for inflation, thus increasing each year, until it drops back down in 2026.

1. GIFTING - *continued*

- Thus, in 2026, the exemption amount will drop to $5 million, which indexed for inflation is expected to be approximately $6.5 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 at a later date.
- The proposed regulations allow taxpayers to rely on this no claw back provision.
- With uncertainty whether the November election could lead to a power shift and a possible reduction in the estate tax exemption amount, clients should be considering gifting their full exemption amount if they can afford to do so.

1. GIFTING - *continued*

- In California, we have seen recurrent attempts to impose a CA estate tax, though no measure is on the Nov. ballot.
- Though not successful to date, imposition of a CA estate tax could happen in the future.
- And, given state and federal budgetary shortfalls due to the COVID-19 crisis and general deficit spending, we see pressure to raise taxes on the wealthy.
- Joe Biden's recent tax plan aims to lower the exemption amount to $3.5 million should he be elected.

1. GIFTING - *continued*

- Clients who can afford to gift should consider doing so to reduce their eventual estate tax due.
- The ability to do such gifting might 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 of a majority interest in a private company:

- Succession planning is a key milestone in a company's lifecycle and should be done proactively, not reactively.
- The uncertainty of the past year, in which the economic effects of the pandemic have hit vastly differently across various industries, has shown that proactive planning provided company owners with the best options.
- Founders and other owners will decide to sell all or part of their business in the coming years for a variety of reasons.
- While valuations are down in 2020 across a wide variety of sectors, other areas of the economy are booming.

2. Planning for the full sale or of a majority interest in a private company: *continued*

- Meanwhile, investment capital is still at high levels and buyers are looking to invest in private companies – distressed or soaring.
- Joe Biden's recent tax plan aims to get rid of a preferential tax rates on capital gains and dividends.
- Thus, for those company owners undecided about the timing of selling their business, the potential doubling of the capital gains tax could be a deciding factor.

3. Sale of capital assets

- The current tax rate on the sale of most capital assets is 20% plus the 3.8% Medicare tax.
- Joe Biden’s tax proposal will end the preferential capital gains rate and will tax capital gains and dividends at almost 40%.
- Interest for certain capital assets, especially music interests – which will often get capital gains treatment – remains high.
- Revisit intellectual property rights which might be subject to a capital gains tax rate and determine if now is a good time to sell for planning purposes.

4. Gifting of real estate to children

- This November 3, 2020, Californians will vote on Proposition 19, amending the CA Constitution's current property tax system.
- If the proposed amendment passes, it will narrow the Proposition 58 parent-child exemption from property tax reassessment.
- Property is taxed by local governments most typically based upon its assessed value. Proposition 13, enacted by California voters in 1978, mandates limited, 2% annual property tax increases, unless there is (1) a change of ownership, or (2) completion of new construction. Then, property tax values go to fair market value.

4. Gifting of real estate to children - *continued*

- Because of Proposition 13, while a California property is maintained under the same ownership and no triggering event occurs, then the assessed value of the property will increase by no more than 2% annually for property tax purposes, regardless of the actual market value of the property.
- As a result, some property owners in California have owned property for decades while seeing only these limited property tax increases, despite great appreciation in the property's value.
- Proposition 58, enacted in 1986, creates an exception to Proposition 13.
- Under this measure certain transfers of California real property between a parent and their child are exempt from reassessment, despite such transfers constituting a change of ownership which would otherwise trigger reassessment under Proposition 13.

4. Gifting of real estate to children - *continued*

- Specifically, the parent-to-child transfer of (1) a primary residence, and (2) the first $1,000,000 of assessed value of other real estate (both residential and commercial) are exempt from reassessment and thus property tax increases.
- The assessed value is the value on the property tax bill, not the property's market value, thus allowing for property worth well more than $1,000,000 to be transferred without reassessment.
- This exemption can apply to grandchildren in limited circumstances under Proposition 193.
- The California Assembly and Senate approved Proposition 19 earlier this year, to include it on the November ballot.

4. Gifting of real estate to children - *continued*

- Proposition 19 will materially limit the scope of the Proposition 58 parent-child exemption.
- If passed, parents-child transfers, including gifts, become subject to property tax reassessment unless the child uses the property as their primary residence.
- And only $1,000,000 of market value escapes reassessment, even where the transferee uses the property as their principal residence.
- Additionally, if passed, Proposition 19 will allow property owners aged 55 and older, persons with severe disabilities, and victims of natural disasters and hazardous waste contamination to transfer their assessed property values to a different home of equal or greater market value.

4. Gifting of real estate to children - *continued*

- Currently, such a transfer is only allowed for properties of equal or lesser value. Such transfers would be possible anywhere in the state (currently not allowed), and could be done three times by the taxpayer (currently one).
- If passed, with a majority vote, the measure takes effect on February 16, 2021. Revenue generated by the measure go to agencies that fight wildfires, and to counties where the reassessed properties are.
- Clients considering transferring CA property to a child should understand the risk that this exemption, which can make a sizable difference in certain circumstances, will disappear.

5. Planning for the possible more frequent reassessment of commercial real estate

- California Proposition 15, also on the CA ballot in November, will dramatically change property taxes on CA commercial real estate.
- If passed, the ballot initiative amends the CA Constitution to require commercial and industrial properties, except those zoned as commercial agriculture, to be taxed based on their market value.
- In California, the proposal to assess taxes on commercial and industrial properties at market value, while continuing to assess taxes on residential properties based on the purchase price, is termed ***split roll***.
- The change from the purchase price to market value would be phased-in beginning in fiscal year 2022-2023.

5. Planning for the possible more frequent reassessment of commercial real estate – *continued*

- Properties, such as retail centers, whose occupants are 50 percent or more small businesses, would be taxed based on market value beginning in fiscal year 2025-2026 (or at a later date decided by the legislature).
- The ballot initiative will continue taxing properties, whose business owners have $3 million or less in CA commercial real estate based on their purchase prices.
- The ballot initiative also exempts a small business's tangible personal property from taxes along with $500,000 of a non-small business's tangible personal property.
- Client's holding commercial real estate in California should undertake calculations to determine the impact of tax changes under Proposition 15.
- In some cases, the additional property tax might make their current holdings untenable financially and should be sold.

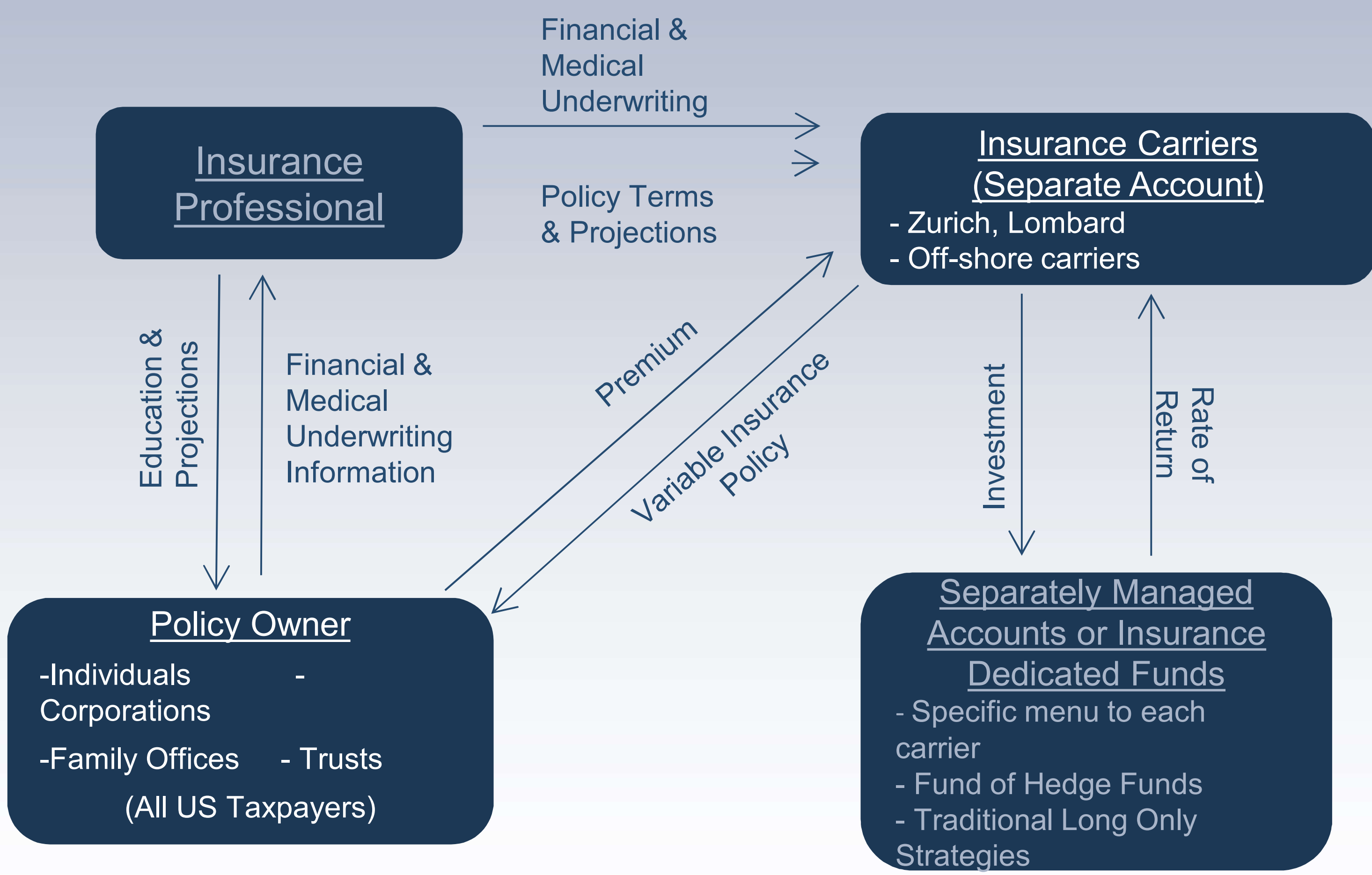
6. Private placement life insurance (PPLI)

- No federal or state income tax on income or gains inside the policy – tax free redeployment.
- Appreciation can be borrowed during lifetime with no income tax.
- Death benefit is exempt from income tax.
- Allows investing in foreign funds without penalty.
- Reduces reporting ("No-K-1s!").

6. PPLI (continued)

- Drawbacks
  - Cannot manage the money yourself.
  - Must either appoint an independent investment manager or invest in insurance dedicated funds.
  - Account must be diversified.
  - At least 5 assets in specified proportions.
- Not your father's life insurance policy.
  - This is about reducing income tax, not insuring against mortality or creating a pool of liquidity.
  - You can hire any RIA to manage your account.
- What does it cost?
  - All in fees over 5 – 7 years should average around 100 – 125 basis points per year.
  - Includes carrier administration fee, cost of insurance, agent's commission and amortization of up front costs.
  - 53% federal and CA tax on 2.5% return is ~ 132 bps.
  - If you are not earning 2.5%, fire your broker!
  - If earning 3% or more, PPLI is huge win!

6. PPLI (continued): Diagram



7. 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.
- The structure is basically 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 controlled.
- 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.

7. Creating a family limited partnership (or LLC): *continued*

- The value of the gifts 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.

8. Updating old documents:

- Over time, even well drafted company, partnership or estate planning documents become dated.
- 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.
- 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.

9. Maintaining 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.
- And, financial institutions are tightening lending and flexibility on payment terms.
- All individuals and businesses should ensure that they have enough liquid capital to survive an unexpected catastrophe or further, extended lockdowns.

10. Legislative Retroactivity

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

11. Biden tax proposals: Personal income tax

- Taxable income above $400,000 taxed at 39.6%.
- LTCG and qualified dividends taxed at 39.6% (plus NII) if income exceeds $1,000,000.
- No step-up in basis at death (possible mark to market taxation).
- Itemized deduction benefit limited to 28% cap.
- Pease limitations on itemized deductions are restored for taxable incomes greater than $400,000.
- QBI (Section 199A) deduction phased out for taxpayers having taxable income greater than $400,000.

11. Biden tax proposals: Social security increases

- Current OASDI tax is 12.4% up to $137,700 wage base
- New OASDI tax would be 12.4% on compensation income above $400,000; donut on compensation between wage base and $400,000
- Medicare tax remains at 2.9% on all compensation plus 0.9% on compensation in excess of $250,000

11. Biden tax proposals: Corporate taxation

- Increase in corporate income tax rate from 21% to 28%.
- New alternative minimum tax of 15% on book profits if $100M or higher.
- GILTI tax deduction reduced from 50% to 25% which when combined with corporate tax rate increase doubles GILTI tax rate from 10.5% to 21%.
- VAT (?) not likely.

11. Biden tax proposals: Estate & gift taxation

- Likely to follow Obama Greenbook proposals.
- Exemption amount decreases from $11.58M to $3.5M per person (indexed).
- Significant limits on valuation discounts.
- Grantor trust = Estate includability.
- Wealth tax (?).

Conclusion

- Act Fast!
- Reach out to outside advisors when needed!

Presenters

Megan Jones
Withers Bergman LLP
megan.jones@withersworldwide.com
310-228-5742

Paul Sczudlo
Withers Bergman LLP
paul.sczudlo@withersworldwide.com
310-277-9916

Paul Sczudlo

Of Counsel | Private client and tax

Education

Yale University, BA
University of California, Berkeley – School of Law, JD

Recent Activities

'U.S. Tax Residency, COVID-19 and Beyond,' STEP LA Webinar - June 24, speaker

'Super-Rich Stranded by Lockdowns Face Higher Tax Bills,' Bloomberg News and Bloomberg Tax - May 12, quoted

Paul has over 35 years' experience focused on global planning matters. He is widely recognized for his practice in cross-border and entertainment tax planning. His clients have ranged broadly from high-net-worth individuals; foreign investors in U.S. real estate and other U.S.-situated assets; Americans with offshore investments, acquisitions and business activities; and actors, musicians, writers, producers, directors and agents; to film production and distribution companies; public and closely-held businesses; and financial institutions.

Paul's practice emphasizes entertainment taxation; international income taxation; international estate and gift tax planning; international estate administration; international wealth transfer planning; other international planning for high-net-worth individuals; inbound planning for businesses seeking to set up, acquire or dispose of, manufacturing, distribution, licensing or other operations in the United States; outbound planning for U.S. businesses establishing or acquiring foreign operations; international tax withholding; and cross-border tax reporting, compliance and controversy issues.

Paul writes and lectures regularly on international and other tax topics of interest to businesses and high net worth individuals. He has been recognized as a Super Lawyer since 2004 and as a Best Lawyer since 2006. Paul is ranked as a Leading Individual in Tax in Chambers USA 2020, and was first ranked in 2004.

Paul is secretary of Society of Trust and Estate Practitioners (STEP USA) and chair of the Los Angeles Branch (STEP Los Angeles). He is a past chair of the American Bar Association's International Private Client Committee, the California State Bar Association's International Tax Committee and the Los Angeles County Bar Association's Taxation Section.

Megan L. Jones

Associate | Private client and tax

Megan advises individuals, family offices, investors and companies on domestic and international tax planning. Her practice includes the intersection between income tax, estate and corporate planning. Megan handles diverse matters for high-net worth individuals facing sophisticated challenges.

Previously an investment banker at a global firm with an international focus, Megan has done extensive cross border work. She has also advised startup companies and their founders, from the foundational stages to a recognition event. Megan understands how to plan in the context of intangible assets or innovative technology. Her grasp of complex financial statements adds a level of sophistication to her practice.

Megan is an adjunct professor at Loyola Law School. She speaks and writes on tax-related topics and has written three books. An active member in the legal community, she serves in leadership roles including the planning committee of Society of Trust and Estate Practitioners' (STEP) Los Angeles Branch. She is on the tax executive committees of the Los Angeles County Bar Association and Beverly Hills Bar Association, and also is a member of both CalCPA's estate planning state and Los Angeles planning committee.

Education

Pepperdine University, BS
Loyola Law School, JD

Recent Activities

'U.S. Tax Residency, COVID-19 and Beyond,' STEP LA Webinar - June 24, speaker

'Coronavirus Working Group Focuses on International Tax Issues,' Tax Notes – May 14, co-author