Estate Planning in a High Income Tax Environment

2016

Background
Recent legislation has increased the income tax rates on the highest-earning Americans. This occurred as the result of two distinct pieces of legislation: the American Taxpayer Relief Act of 2012 ("ATRA") and the Affordable Care Act ("ACA"). As a result of the passage of these two bills, the highest marginal rates for items of income at the Federal level have increased to the following:

- Earned Income: 40.5%
- Taxable Interest/Short Term Capital Gain: 43.4%
- Qualified Dividends/Long Term Capital Gain: 23.8%

In addition, several states have increased their personal income taxes as well, resulting in some of the highest combined federal/state income tax rates in two generations. During the low tax environment of the Bush-era, several estate planning techniques that had the ability to defer or even avoid income taxes were marginalized. Given the new high-tax environment, it is likely these strategies will see renewed interest. This paper will explore some of the most popular of these techniques, reviewing their structure, purposes from an estate planning viewpoint, and their income tax deferral affect.

This paper is not intended as an exhaustive discussion of each strategy, and necessarily simplifies the analysis of each to focus on the income tax advantages and/or disadvantages of each technique.

Charitable Remainder Trusts ("CRTs")
Broadly speaking, there are two types of CRTs: (i) a Charitable Remainder Annuity Trust (CRAT) pays the income beneficiary a fixed dollar amount each year (the annuity amount), and (ii) a Charitable Remainder Unitrust (CRUT) pays the income beneficiary a fixed percentage of the fair market value of the trust’s assets as reetermined each year (the unitrust amount). Because the income beneficiary can participate in the upside if the assets in a CRUT increase in value, CRUTs tend to be more popular than CRATs.

A CRT has two distinct income tax advantages to the donor. First, the donor receives an income tax deduction based on the difference between the value of the donor’s interest and the value of the property transferred to the trust. In addition, the CRT itself is not subject to income tax. Consequently, the CRT is a popular strategy for philanthropic owners of a low basis, highly appreciated asset. The asset can be donated to the CRT, for which the donor receives an income tax deduction (typically equal to 10% of the value of the donated asset). The asset can then be sold inside the CRT without tax being paid on this initial sale. However, the annual distributions are, in general, taxable to the recipient and the character of the income is based on the income earned by the trust. Distributions from the CRT are deemed to occur in the following order: interest, dividends, qualified dividends, short-term then long-term capital gains, tax-exempt income and, finally, principal of the trust (tax-free). This is generally referred to as “worst first” tax treatment.

Despite the treatment of the distributions, a CRT can be valuable in a high tax environment upon the sale of a highly appreciated asset. For example, an owner of $1MM worth of zero-basis stock who sells the stock in his capital account will owe Federal long term capital gains tax of $238,000, leaving the owner of the stock with $762,000 ($1MM less 23.8% of the sales proceeds) to reinvest in a diversified portfolio. If the owner instead donates the shares to a CRT, the owner receives an income tax deduction for the donation. The trustee of the CRT can sell the shares without paying any income tax and reinvest the full $1MM of sales proceeds in a diversified portfolio.

CRTs are often coupled with other techniques, such as ESOPs (see below) and so-called “wealth replacement trusts” or Irrevocable Life Insurance Trusts (“ILITs”)
Employee Stock Ownership Plans
An Employee Stock Ownership Plan (“ESOP”) is one of several ways a business owner can convert a concentrated, illiquid equity position into a diversified portfolio in a single transaction. An ESOP is a retirement benefit plan created to hold the corporation’s own stock for the benefit of employees. A sale of the business owner’s stock to the ESOP has two important features. First, the ESOP allows employees to have an ownership stake in the company. Second, if the requirements of Internal Revenue Code section 1042 are met, the sale of the business owner’s stock to the ESOP will not be subject to capital gains, and in some circumstances the capital gains tax can be avoided entirely.

Sales to ESOPs must meet many requirements in order to comply with section 1042 and the applicable regulations. A full discussion of those requirements is beyond the scope of this paper, but some of the more important ones include:

- The equity to be sold to the ESOP must consist of “qualified securities”, generally common stock of a C Corporation;
- The ESOP must end up owning at least 30% of either each class of the corporation’s outstanding stock or the total value of all the corporation’s outstanding stock after the sale is complete;
- The business owner must purchase “qualified replacement property” (QRP) within a 15-month period starting three months prior to the date of the sale and ending twelve months after it. QRP generally consists only of U.S. corporate common stock (including Subchapter S corporation stock), preferred stock, bonds and convertible bonds.

The value of a sale to an ESOP depends in part on how long the capital gains tax on the company stock can be deferred. The deferred capital gain on the sale is triggered on a “disposition” of the QRP. Clearly, an outright sale of the QRP will be considered a disposition. However, a disposition does not include a gift or death of the seller.

Since a gift is not a disposition, the selling shareholder could transfer the QRP to a CRT and dispose of the QRP within the CRT without triggering capital gain. As an alternative, the selling shareholder may take a margin loan against the QRP. However, this carries with it risks that the loan will be called or the income generated by the QRP is insufficient to meet the interest expense of the margin loan.

Finally, if the owner simply holds the QRP until his or her death, then the basis of their property, including the QRP, will be “stepped-up” to the fair market value at that time. Thus, the capital gain will be avoided altogether, but the assets will nevertheless be subject to estate tax.

Life Insurance
Life insurance can be used for many purposes, including income replacement in the event a family breadwinner dies during their earning years and/or to provide liquidity for an estate to pay estate taxes or other expenses.

Cash value life insurance can also act as a tax deferred investment. In a traditional policy, the investor makes premium payments in excess of the pure cost of the life insurance death benefit. The excess is placed in an investment account. The returns on this account can be determined by the insurance company (whole or universal life) or fluctuate based on the market value of the investments in the account (variable life insurance).

An advantage of investing in a life insurance policy is that during the period when the policy is in place, the investment account earnings, if any, are tax-deferred.

Disadvantages are that investing in a life insurance policy may be expensive, as there are initial sales loads which reduce cash value, ongoing charges against the policy for the underlying investments, as well as costs to maintain the life insurance component. In addition, accessing the account during the life of the insured requires a loan against the policy (for which interest charges are incurred) or, a cash-out of the policy (which results in ordinary income tax treatment of any gains).

Qualified Small Business Stock
Generally, individual taxpayers may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for more than five years (IRC section 1202). The excess was taxed at a rate of 28%. Because the federal capital gains tax rate was 15% under prior law, this made the use of the Qualified Small Business (“QSB”) exclusion of limited value, and in fact many tax payers holding eligible stock simply ignored it. However, recent tax law changes have made the exclusion far more attractive.

For stock acquired after February 17, 2009 but by September 27, 2010, the exclusion was increased to 75 percent. For stock acquired after September 27, 2010 and before January 1, 2011, the excluded amount was increased to 100 percent. The 2010 Tax Relief Act further extended the 100 percent exclusion through December 31, 2011. The ATRA retroactively extended the exclusion of 100 percent of the gain from Qualified Small Business Stock to stock acquired after September 27, 2010 and before January 1, 2014. The PATH Act now renews and permanently extends the 100% exclusion for all Qualified Small Business Stock acquired after September 27, 2010.

Qualifying Small Business Stock is stock from a C-corporation with gross assets that do not exceed $50 million (including the proceeds received from the issuance of the stock) and which meets a specific active business requirement. The amount of gain eligible for the exclusion is limited to the greater of ten times the taxpayer’s basis in the stock or $10 million of gain from stock in that corporation.
IMPORTANT DISCLOSURES

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources and Morgan Stanley Smith Barney LLC ("Morgan Stanley") makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley Smith Barney LLC. It does not provide individually tailored investment advice. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions and transaction costs applicable to any given client may affect the consequences described, and these analyses will not be suitable to discuss with every client. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

Any historical data shown represents past performance and does not guarantee comparable future results. Indices are unmanaged. An investor cannot invest directly in an index.

Diversification does not assure a profit or protect against loss in declining financial markets.

Morgan Stanley Smith Barney LLC offers insurance products in conjunction with its licensed insurance agency affiliates.

Unlike other types of insurance policies, variable life insurance is subject to market risk and may not be appropriate for all investors. Because the value of the policy fluctuates with the value of its underlying securities portfolio or other index of performance, losses or gains in the equity or bond markets may significantly impact the investor’s death benefit. Although the insurance company typically agrees to provide a minimum death benefit unaffected by portfolio losses, the amount of this benefit may be lower than the benefit offered by other types of insurance policies. All guarantees are backed by the claims-paying ability of the issuing insurance company.

Both the return and the principal value of the portfolios in the policy will fluctuate, and the portfolios may be worth more or less than their original costs when redeemed.

Any withdrawal or unpaid policy loan balance and interest will reduce the policy’s death benefit and cash value. Interest on loans will be billed annually. If the amount due is not paid, it will be added to the amount of the loan and next year’s interest will be based on this new loan amount. If a loan is outstanding and the policy lapses, a taxable event may occur. Policy loan repayments may be made at any time.

If the policy is a MEC (Modified Endowment Contract), there may be additional taxes and penalties on any distributions from the policy during the lifetime of the insured. Any distribution from a policy that is a MEC will be taxed on an "income-first" basis. Distributions for this purpose include a loan (including any increase in the loan amount to pay interest on an existing loan or an assignment or a pledge to secure a loan) or withdrawal. Any such distributions will be considered taxable income to the extent there is gain in the policy at the time of distribution. That is, the distribution will be includible in income up to the amount the account value exceeds the basis in the policy. A 10% penalty tax also will apply to the taxable portion of most pre-age 59 1/2 distributions from a policy that is a Modified Endowment Contract.

Variable life insurance is sold by prospectus only. The prospectus contains the investment objectives, risks, fees, charges and expenses, and other information regarding the variable life policy and the underlying investments, which should be considered carefully before investing. Prospectuses for both the variable life policy and the underlying investments are available from your Financial Advisor. Please read the prospectus carefully before you invest.