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Death is not the only capital gains loophole

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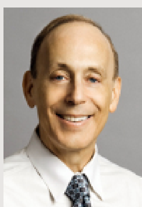

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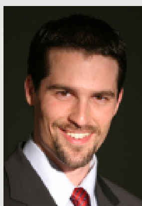

The maximum federal tax rate on long-term capital gains started at 15 percent in 1916 and jumped to 67 percent the next year, reaching the all-time high of 77 percent in 1918. From those heights everything since has, comparatively, been downhill. The second historic high of almost 40 percent occurred in 1976-1978. From Jan. 1, 2008, through Dec. 31, 2012, the tax returned to its original rate of 15 percent, the historic law. So, on Jan. 1, 2013, when it increased to 23.8 percent, that was not a high rate from a historic perspective. However, from a year-to-year change it was an almost 60 percent increase. For California taxpayers making over $1,000,000, the total became 37.1 percent, just slightly under the federal maximum rate over the past 90 years.

Assume Dad and Mom, California maximum-bracket residents, ages 85 and 80, bought an apartment building for $1,000,000 30 years ago. It is now worth $3,500,000; is not subject to debt; has been depreciated down to $500,000; and generates $175,000 per year of positive cash flow. If Mom and Dad sell the building they will incur a ($3,000,000 times 37.1 percent equals) $1,113,000 tax. They can enter into a tax-deferred exchange under Internal Revenue Code Section 1031. What if they do not want to continue to invest in real property? Another alternative is to transfer the apartment building to a charitable remainder unitrust. When the trust sells the property, it need not pay a capital gains tax. Mom and Dad will get a current income tax deduction for the present value of a charity's right to receive the assets on their death ($1,965,390), and they will get a payment of 5 percent of the fair market value of the assets each year for as long as either one of them is alive. (They can choose a payout rate of as much as 6.907 percent. However, that will reduce the charitable deduction to $1,380,089.75.) What if they want the assets, on their death, to pass to their children? They could use some of the cash flow to buy an insurance policy. However at their ages, the insurance might be so expensive as to require most of the cash flow.

Often the best advice is to hold the property until the death of the first of Mom or Dad. Death is a capital gains tax loophole. This way the property's basis will "step up" to the date of death fair market value. Internal Revenue Code Section 1014. The surviving spouse's sale will incur no capital gain tax. What if Mom and Dad are a healthy 85 and 80, and they do not wish to wait that long to liquidate their investment? Happily, there is another way.

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Mom and Dad should set up an irrevocable non-grantor trust for the benefit of their children. They need an independent appraisal of the building. They will then give $400,000 to the children's trust. Then they agree to sell the building to the children's trust for $350,000 down and a $3,150,000 nine year note. Since the note is for nine years or less, the family can use the mid-term "applicable federal rate" set by the Internal Revenue Service, which is 1.73 percent for November 2013. The children's trust will owe Mom and Dad ($3,150,000 times 1.73 percent equals) $54,495 per year. The children's trust will be receiving $175,000 per year of net cash flow from the building on which it will have to pay tax. Even if the trust owes 50 percent in state and federal tax, it will still have more than enough to pay the interest to Mom and Dad.

Once two years and a day have transpired, the children's trust can put the building up for sale. When it is sold, the children's trust can use the price it paid Mom and Dad as its basis for determining the tax consequences. Assume that the sales price to the cash buyer is $3,500,000 net of selling expenses. The children's trust will owe no tax and will deposit $3,500,000 into its bank account. As long as the children's trust does not pay off the principal on the note, Mom and Dad owe no capital gains tax. Mom and Dad have the benefit of a sale - the cash is in the bank account of someone they trust (the children's trust) - without having the disadvantage of seeing over $1 million paid in tax. If Mom and Dad need more than the interest payments, the children's trust can pay principal on the note or make loans to them (on commercially reasonable terms).

What if Mom and Dad are a healthy 85 and 80, and they do not wish to wait that long to liquidate their investment? Happily, there is another way.

One big disadvantage is that there will be no step-up in basis on the first parent's death. However, as long as the note principal is not paid, the tax on the gain is not due. That note may remain outstanding for decades. In our experience, at the end of two or three decades, the parties are happy that they received the benefit of the earnings on what would have been paid in taxes and want to pay off the note and pay the tax that would have been due 20 or 30 years earlier.

One minor disadvantage of this approach is that if a taxpayer has more than $5,000,000 of installment notes outstanding, the taxpayer owes interest (the current rate is 3 percent) to the government on the gain above $5,000,000. Another disadvantage is that this does not work with publicly traded securities.

One big advantage of this structure is that all future appreciation on the building is removed from Mom and Dad's taxable estates. Therefore, for estates that may be subject to an estate tax despite the current $10,500,000 per couple exclusion, this technique has a wonderful side benefit.

Death is a capital gains loophole. However, it is not the only type of estate tax planning that packs a capital gains tax savings benefit.

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