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Anticipating Elizabeth Warren's wealth tax

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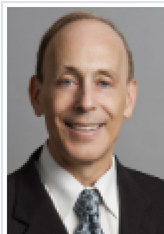

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Sen. Elizabeth Warren in San Diego, Oct. 3, 2019. (New York Times News Service)

Democratic Presidential Candidate Sen. Elizabeth Warren has proposed an annual 2% tax on those with a net worth over $50 million, and a 3% tax on those with a new worth above $1 billion. (Candidate Sen. Bernie Sanders has an even more aggressive proposal: 1% for those with a net worth above $32 million rising to 8% for those with a net worth over $8 billion.) She calls it the "Ultra-Millionaire Tax." One poll indicates two-thirds of Americans — including Republicans — support Warren's wealth tax. One estimate is this would raise $2.75 trillion over a decade from the 75,000 richest households. This was influenced by the work of French economist Thomas Piketty, whose book "Capital in the Twenty-First Century," put a spotlight on the increasing disparity of wealth in developed nations.

Much has been written about how, for example, France's wealth tax contributed to the exodus of an estimated 42,000 millionaires between 2000 and 2012. In 2018 President Emmanuel Macron ended the tax. In 1990, 12 European countries had a wealth tax. Today, there are only three: Norway, Spain and Switzerland. Reportedly it raised little revenue, distorted saving and investment decisions and pushed the rich and their money out of the taxing countries.

In March, 1977 Professor George Cooper wrote an article for the Columbia Law Review titled "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance." His conclusion was that no family need pay the estate tax since there were so many ways to plan around it. What was true then is still true 42 years later. For that reason the Warren wealth tax, if enacted, will fail to raise the projected revenue.

Take the example of Mom and Dad, ages 62 and 65, worth $200 million in apartment buildings located in Los Angeles. The cap rate is 3% (there is $6 million of distributable cash flow). How would they get their taxable estate to zero?

Step 1: Though Mom and Dad feel the buildings are worth $200 million, they mean they would not sell them for less $200 million. However, a competent real estate appraiser values the properties at 90% as much, e.g., $180 million.

Step 2: Mom and Dad form a family limited partnership. The family limited partnership's general partner is an LLC wholly owned by an irrevocable trust for the benefit of their four children with a 2% interest as a general partner. Mom and Dad are the 97% limited partners. The children's trust is the 1% other limited partner.

Step 3: Mom and Dad transfer an undivided 3% interest in each property to the children's trust, which is a reportable gift. This does not cause a property tax reassessment due to the properties' low assessed value (Mom and Dad have held them for decades) and the $1 million per parent property tax reassessment exception for non-principal residence real estate.

Step 4: The children's trust transfers two-thirds of what it has received as a gift to fund the LLC, which is the general partner.

Step 5: Mom and Dad contribute their 97% interest in each property; the LLC contributes its 2% interest in each property; and the children's trust contributes its 1% interest in each property to the family limited partnership in exchange for partnership interests.

Step 6: We determine the rate the children's trust must pay the parents pursuant to a private annuity. If the children's trust can make this level of payments for as long as either Mom or Dad are alive, Mom and Dad have a zero taxable estate as soon as they sell the asset to the children's trust. In this case, at ages 65 and 62, the annuity rate is 5.224961%. Since the children's trust is a grantor trust for income tax purposes, it is disregarded and, therefore, Mom and Dad's sale of partnership interests to the trust does not cause a taxable gain.

Step 7: A business appraiser determines the aggregate gift value of the limited partnership interests is: $180 million *x* 60% (to allow for a combined 40% discount for lack of marketability and lack of control, since what is being sold is LP interests) = $108 million.

Step 8: $108 million multiplied by the annuity rate (5.224961%) means the children's trust must pay Mom and Dad $5,642,957.54 per year to complete the transaction and make the assets disappear from Mom and Dad's taxable estate. Since the distributable cash flow is $6 million, the transaction works well.

Step 9: When parents sell assets for a private annuity to a children's trust, an "exhaustion test" must be met. This requires the trust to have enough assets to make the payments until the parents reach age 110. In this case, for every million dollars the children's trust buys, it must have $670,000 of other assets. Sometimes the parents first make a large gift to the children's trust so it has sufficient assets. Sometimes the children individually can guaranty the trust's obligation (if they have the net worth to make the guaranty worthwhile). Otherwise, the children's trust may be able to entice someone else, e.g., an aunt or uncle, or a closely held business to guaranty the obligation in exchange for a guaranty fee. In this case assume Mom's brother is a wealthy man who agrees to guaranty the obligation for a reasonable guaranty fee.

The point is we know how to make even a $200 million group of assets disappear from the estate of Mom and Dad for estate tax purposes and, therefore, avoid the proposed wealth tax. Since there are four children, and each of them now has — through the trust — a net worth of about $50 million — none will be subject to the proposed Warren wealth tax.

If Mom and Dad have other valuable assets, e.g., a $20 million personal residence, there are other techniques to either get their taxable estate to zero or get it below the $50 million amount at which the Warren wealth tax would apply. The point is that if you fail to plan, you plan to fail. □