A Big Tax Bite Under "BRACKET CREEP"

If Your Company Starts Getting Prosperous You Could Be Moving Into a Disastrous Tax Problem Through Creeping Up

Most wall and ceiling contractors have heard of "bracket creep"—when progressive taxation takes a bigger bite from increased income, leaving inflation to erode the remainder's purchasing power.

Many in business forget that estate and gift taxes are progressive also. While inflation statistics have been lately encouraging, even a five percent rate over 20 years will nearly triple a $1 million estate to $2.7 million in taxable value.

Congress has reduced the statutory estate and gift tax rates in recent years. But while income tax rates will be indexed to the rate of inflation beginning next year, estate and gift taxpayers will enjoy no such protection against bracket creep.

Unexpected estate and gift taxes have ruined many a business and family. But don't despair! A "freeze" movement is underway—offering several legal and effective ways to freeze estate values at today’s prices, and thereby avoid higher taxes through bracket creep.

Three principal methods exists for freezing the value of a closely held business (and three for other non-business assets). Each technique is legal, proven through much experience, but individual circumstances require the advice of an accountant and a lawyer.

Recapitalization. Known as a "recap," the senior stockholder in a recapitalization exchanges his common
stock for an equally valued interest of
preferred stock, redeemable only at (or
a slight premium above) a fixed par
value.

Of course, stock can be difficult to
value. But since the value of preferred
shares received cannot exceed the
common shares surrendered, expert
accounting advice is critical.

The senior stockholder debating a
recap should consider the voting rights,
dividends and control over the business
he desires. Properly planned, a recap
can substantially reduce estate tax
liability.

At the same time, certain legal issues
involving the Internal Revenue Service
should be considered:

• Correctly handled, gifts of com-
mon stock made in exchange for
preferred stock will not result in a gift
tax liability. Once a gift tax return is
filed, the IRS has a three-year statute
of limitation—but may extend the
statute another three years if it can
prove a gift undervalued by more than
25 percent. Also, an understatement
can impact the tax rate applied to later
gifts or to the donor’s estate.

• If the common stock given away
is undervalued, the IRS can increase
the donor’s tax liability by claiming the
preferred stock received in exchange
was not sufficiently discounted.

Holding Company. Recapping
results in a lateral shift of interest—
the senior stockholder receives pre-
ferred stock by giving an equal value
of common stock. But when multiple
assets such as other operating
businesses are involved, or when
several senior stockholders such as
brothers and sisters desire equal treat-
ment, a recap may not serve.

An alternative is the creation of a
holding company. Similar in principle
to the recap, this “freeze” technique
instead has the senior stockholder ex-
changing common stock for fixed par-
value voting preferred stock with the
holding company—as other stock-
holders then receive the common stock
from the holding company.

If the senior stockholder retains
voting control, he can liquidate the
holding company and, as assets are
distributed, regain control of family-
held shares.

Family Partnerships. A closely-held
corporation can be restructured into a
family partnership so that, by exchang-
ing present interests for fixed capital
interests, certain family members re-
main unaffected by appreciation from
growth or inflation. In this way, the
value of a senior partner’s interest can
be frozen.

An existing family partnership can
also be restructured to establish dif-
cerent classes of ownership interests.

A fixed interest may be a general or
a limited partnership interest. But a
limited interest is most akin to pre-
ferred stock—the partner’s liability is
limited, and he receives guaranteed or
preferred payments—plus a set
amount upon the disposition of his
capital account.

The value assigned to the frozen in-
terest should control for estate and gift
tax purposes if arrangements are prop-
erly documented and negotiated at
arm’s length.

Other Assets . . .

A significant portion of any estate
will consist of assets other than in-
terests in closely-held corporations or
partnerships—such as businesses
owned in sole proprietorship, stock
and securities, or real property. Three
basic methods for freezing the value of
these estate assets have been
developed:

Installments Sales. To spread out the
tax burden, a taxpayer can sell assets
to heirs directly or through an irre-
vocable trust with a long-term install-
ment contract. This freeze technique
has many advantages:

• The asset’s value is frozen at the
face value of the installment sales note,
for estate tax purposes.

• By limiting the year-to-year gain,
the entire gain can be deferred until the
final year of payment. Also, the tax-
payer is usually subject to lower tax
rates in the retirement years. And he
is no longer liable for income produced
by the asset—though this is offset
somewhat by interest income realized
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through the installment period.

• The timing of payments can be planned to meet the needs of buyer and seller. If the seller—presumably the more established party—can finance the cost plus interest, he can help the buyer’s cash flow by deferring payments (or by requiring a “balloon” payment at the end of the note’s term) while at the same time providing more income for his retirement years.

However, a few words of caution: Gift taxes may be owed if the IRS believes an asset has been sold below market value. Also, assets sold by installment cannot be immediately resold by a family member-buyer or trust, but must be held at least two years—or in the case of securities, for the length of the installment agreement.

If the sale is not completed before the seller’s death, but remaining installments are bequeathed, the estate or the beneficiary must pay the tax on the balance of the gain.

Private Annuities. If an asset is highly marketable and enjoys great appreciation potential, and if the taxpayer’s heirs have trustworthy financial management skills, a private annuity may be an attractive freeze technique—especially for elderly persons.

The asset is transferred to family members in exchange for an annuity. None of the asset’s value is included in the taxpayer’s estate, since he receives only the annuity payments.

The buyer is also free to immediately resell the asset, and will often incur no gain or loss since the annuity obligation assumed offsets the resale gain realized.

Charitable Lead Trusts. When making a lifetime gift of property to a family member, the taxpayer may provide that a charity receive a fixed share of the produced income until his death or for a chosen period. The amount or percentage received by the charity is based upon the property’s fair market value at time of transfer.

The value of the property is frozen for purposes of the donor’s estate, and any future appreciation transferred to the donee.

Depending upon the time length of the charity’s interest, the property’s value can be actuarially reduced. In this way, the donor’s gift tax liability for the remaining income received by family members is minimized.

However, the donor cannot claim a tax deduction for the current income interest granted the charity.