What Mitt Romney's Tax Returns Teach Us About Accumulating Wealth

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The income tax return information released by Governor and Mrs. Romney (the "Romneys") reveals a well-thought out strategy for transferring wealth to the next generation. Certainly, Governor Romney was successful at Bain Capital and created considerable wealth for himself. What stands out in the eyes of tax advisors is that the Romney family trust has an estimated one hundred million dollars of assets. Regardless of your political preference, one must acknowledge the success of a plan that resulted in the transfer of such wealth.

Most readers are familiar with the estate tax but few are aware that transfers from a grandparent to a grandchild are subject to the Generation Skipping Transfer Tax ("GST") at the highest estate tax rate in effect. Transfers out of trust to a grandchild may also be subject to the GST. Were it not for the GST, the government would not have an effective transfer-tax system, because property could be easily placed out of reach of the estate tax.

Due to the number of topics, this analysis is presented in [to be determined] parts, in order to cover the subject matter in detail.

I. Estate Planning

In 1995, when the Romneys began to execute their plan, they appear to have created a "Dynasty Trust." As we explain below, this is a device to avoid tax. At the time, the estate and gift tax exclusion was $600,000 per individual. Assuming a gift of $1.2 million in 1995, the total in the trust now is about one hundred times the initial amount. One must marvel at the total accumulated. Estate or gift taxes would have consumed almost one-half of those assets if the plan was not implemented. Instead, all of the future appreciation earned by the trust on its initial corpus escaped estate and gift tax.

The key is that the Romneys were willing to let go and not have every asset titled in their own names. They were willing to establish and fund a trust and to allow it to participate in good investment opportunities that were presented along the way. Perhaps the biggest obstacle to wealth transfer is the inclination of the individual to retain control. As we can see below, some measure of indirect control may be maintained, but even that is not enough control for some wealthy individuals.

II. Dynasty Trusts

Dynasty Trusts are intended to avoid estate and GST taxes. A Dynasty Trust is designed to allow wealth to pass to two or more generations by eliminating estate (death) tax at each generation. More importantly, by shifting all future appreciation from investments to the trust early on, the Romneys avoided gift tax on the appreciation of the trust assets. One can imagine that this Dynasty Trust may have been an investor in the Bain Capital's private equity or hedge funds that are, by all reports, extremely successful.

I note that it is often difficult to convince clients to transfer that big opportunity or a crown jewel of the investment portfolio to such a trust. There is a reluctance to give away assets, especially in view of the insecurity caused by the 2008 financial crisis. The tax efficiency of the Romney plan, however, cannot be denied as it has resulted in the transfer of substantial wealth.

The Dynasty Trust may invest in real estate, portfolio stocks and bonds, or in private equity. The ability of the Trust to attract opportunity, transfer wealth, and minimize risk is enhanced by the size of the assets.

III. Private Equity / Hedge Funds/ Alternative Investments

Governor Romney's affiliation with Bain Capital brought opportunities to participate in its private equity and hedge fund investments. Private equity funds are pools of capital received from investors and directed by highly skilled professionals into private businesses at different stages of development. The skill of the professional enables him to achieve a higher return through active management or oversight of the investment. Typically these investments are illiquid, locked-in for five or more years. A typical goal is to achieve capital gain for an individual investor which is taxed at a reduced rate rather than portfolio income. Although the risk is greater, the reward is also much greater than a portfolio stock.

A hedge fund actively trades in financial assets using options, forward contracts, swaps, futures, and a host of other assets in order to achieve a greater return. A hedge fund seeks to exploit anomalies in price to make a profit.

One expects that the Romneys' wealth transfer strategy called for the Dynasty Trust to participate in some of these ventures. This would explain the significant sum in the Dynasty Trust estimated to be on hand in less than 20 years of investing. One suspects that all that money was not earned in an index fund.

A reader should understand that the opportunity transferred to the trust could be real estate, a family business, or an intellectual property asset. Stock portfolios, that are managed for growth, are also suitable candidates.

IV. Grantor Trusts

The Grantor Trust rules were enacted and modified in the years 1924 through 1969. These rules were designed in an era when the income tax rates on trusts were significantly lower than those rates imposed on individuals. Today, the rate structure is reversed but the usefulness of these rules to assist in wealth transfer has taken on a new life. The Service has ruled that a person who

is deemed a "grantor" or "owner" of the trust is responsible for income taxes as they are his or her personal obligation. The fact that a grantor is paying income tax on Dynasty Trust income is not a gift.

When you consider that the Dynasty Trust is designed not to be included in the Romneys' estates for death tax purposes, you give them the ability to make gifts, in the form of income tax payments, that do not reduce their lifetime exclusion. This is, in effect, an unlimited increase in the estate and gift tax exclusion for those who utilize it.

V. Estate Freezes, Discounts and Other Planning

An estate freeze operates in a slightly different manner. An asset that is appreciating in value can be sold to family by a Self-Cancelling Installment Note (SCIN) or contributed to a Grantor Retained Annuity Trust (GRAT) in exchange for an annuity. A class of preferred interests can be created in a recapitalization similar in concept to the old preferred stock bailout. It is easy to see that value and opportunity can be transferred in this way for less than one hundred cents on the dollar.

A great deal has been written about family limited partnerships and other closely held entities (collectively, "FLP") and valuation discounts in the estate and gift tax area. There are numerous cases on the subject which have been covered in the Tax, Trust & Estate News Blog and elsewhere. The essence is that you would not pay full value to become a partner in an FLP if you could not freely transfer the partnership interest, readily trade it on an exchange, or force distributions or FLP liquidation. What is the value of such a partnership interest? It is certainly less than the partner's pro rata percentage of the assets of the FLP. In contrast, if you gave a gift of IBM stock, its fair market value is easily determined. If IBM stock is owned by an FLP, the donee is not receiving stock in a public company but an interest in an entity that is not readily tradable. A former limited partner in the partnership that owned the Yankees said there was nothing more limited than being a limited partner of (the late) George Steinbrenner.

The value of these techniques for wealth accumulation on a multi-generational level is that larger blocks of assets receive professional management. Opportunities can be shifted to FLPs that trustees may be unable or unwilling to take directly. Where control needs to be centralized, it can be maintained by the senior generation in the guise of entity management. The underlying assets are still managed by the investment professionals and business people, but ownership can be transferred without upsetting or changing the structure.

VI. Individual Retirement Accounts

Mr. Romney's IRA provides an opportunity to accumulate ordinary income, tax free, and pass some of it to the next generation. Assume, for a moment, that Gov. Romney were to pass away. He could designate his spouse as the beneficiary, and she could elect to take Minimum Required Distributions (MRD) over her lifetime. The point is that distribution of the entire account can be postponed by the unlimited estate tax marital deduction. When the account passes to a child or children after the death of the spouse, the account may be divided into separate accounts, one for each beneficiary. This would allow the child to use his or her life expectancy to calculate the

MRD. The impact of the foregoing is that tax-free compounding continues net of distributions. A traditional IRA earning 6% will have more money it when the account owner is age 89 than when minimum required distributions began at age 70 ½., assuming only the MRD is taken.

One should also note that a self-directed IRA may have been used to invest in the opportunities offered by Bain Capital. Although there are restrictions, Governor Romney retained the right to access these investments after leaving Bain Capital, thus freeing him from these restrictions. Today, it is not uncommon for self-directed IRAs to be used by real estate and investment professionals.

Roth IRAs do not require distributions to be taken and offer significant opportunity for deferral. Roth IRAs may hold non-traditional investments that are difficult to value thereby obviating the need for an appraisal each to determine the MRD each year.

VII. Charitable Trusts

Charitable trusts vary in type but offer unique planning opportunities, especially for highly appreciated assets. One significant benefit of a charitable trust is that it may receive a contribution of a highly appreciated asset and sell it without paying income tax. The proceeds of sale can be reinvested. When compared with the alternative of paying income tax up front, the charitable trust option results in a larger sum to invest. Annuity payments to charity are made over a period of years. Payment of the annuity over time will hopefully allow the fund to grow leaving more for the remainder beneficiaries than the alternative of a straight sale. Where the seller needs income, the seller receives the annuity and the charity receives the remainder. Although this is a superficial analysis of charitable trusts, there is much planning opportunity hidden in this thicket.

VIII. Conclusion

One take away from the foregoing is that a great deal of wealth can be passed to the next generation if the transfer occurs before substantial appreciation occurs. A smart man learns from his own mistakes and a wise man learns from the mistakes of others. In this case, a wealthy man (or woman) may learn much from the Romneys.

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