Creative Income Tax Strategies – Additional (Technical) Handout

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Roth IRAs

- Roth IRAs are some of the best income tax shelters around.
- They do not pay any income tax on any of their income, other than unrelated business taxable income.

- Examples:
    - A Roth IRA that owns publicly traded stock pays no income tax on the dividends. When the Roth IRA sells the stock with a capital gain, there is no income tax on the sale of stock.
    - When a Roth IRA sells a business, real estate, or any other asset, there is no income tax on the gain.
    - What if a Roth IRA owns mineral interests? It pays no tax on the royalties.
    - When a Roth IRA makes a distribution to the Roth IRA owner, there is no income tax recognition.

- Unlike traditional IRAs, Roth IRAs have no minimum distribution rules during the life of the IRA owner. Tax-free growth can continue throughout the owner’s life and for up to 10 years after the owner’s death.

- The problem with Roth IRAs: You can only contribute any money into a Roth if you have adjusted gross income of less than $228,000. Alternatively, you can convert your traditional IRA into a Roth, but doing so will result in recognizing ordinary income equal to the value of the converted assets.

What if there were a way to contribute assets directly into a Roth without recognizing all of that income?

Believe it or not… THERE IS!

- Here’s how it works:
  - In Year 1, Mr. Smith makes a contribution to his Roth IRA. If the contribution exceeds the amount that is allowed under IRC Section 408, then the excess amount is called an “excess contribution” under IRC Section 4973.

- According to IRC Sections 4973(b) and 408(d)(4), there is no penalty for making an excess contribution to a Roth IRA if the contribution and its growth are distributed to the Mr. Smith before Mr. Smith timely files his Year 1 personal income tax return.

  So, theoretically, if Mr. Smith makes an investment with the contribution that clearly goes south before his return is filed, Mr. Smith may withdraw the contribution before filing his tax return for the next year and will owe no penalty or tax related to the excess contribution.

- If the contribution is not withdrawn by the due date of the return, then Mr. Smith will owe a 6% excise tax on his excess contribution and will need to report that amount on his Year 1 personal income tax return.

- The income and growth in the Roth IRA will be income tax-free just as if there had been no excess contributions.

- Mr. Smith will need to report the excess contribution and pay the tax each year until the excess contribution is repaid to Mr. Smith. Interestingly, when this repayment takes place, there is no requirement that the Roth IRA repay any of the growth in the excess contribution.
- Also, because there is no income tax on distributions from a Roth IRA, there is no income tax paid as a result of the repayment to Mr. Smith. The repayments will be subject to the 10% tax on early withdrawals from the Roth IRA to the same extent that the 10% tax would apply to an ordinary distribution, provided Mr. Smith has not reached the age of 59 ½.

- After the repayment and going forward, the Roth IRA will be treated exactly as if no excess contribution had been made.

When would you want to use this?

- There is a large 6% annual startup fee, but better cash flow, going forward.
- We have modeled various scenarios and have determined that by far the best assets for this technique are rapidly-growing assets with little or no basis, such as profits interests held by private equity managers. For these assets, the after-tax result, compared to owning the profits interest outright, is **dramatic**.

- We have also engineered a way to “soup up” an investment’s IRR by dividing an asset’s expected return into a preferred interest and a profits interest and only contributing the profits interest into the Roth IRA. Many of you may have spoken to your estate tax attorney in the past about gifting or selling just a profits interest to a trust and were told that the strategy does not work. That is true for gift and estate planning purposes because of IRC Section 2701. However, by its terms, IRC Section 2701 **only applies for gift and estate tax** purposes. With only a few exceptions, profits interests are treated favorably for **income tax** purposes, which is what we are planning for here.

Assumptions

Investment: $1,000,000
Rate of Return: 14% per year
Term: 20 years
Withdrawal Penalty: Yes

	Ending Assets	Roth IRA
Without Roth	$8,397,453	-0-
With Roth	$10,139,079	$3,607,618
Roth 13%	$8,482,744	$2,642,024

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Roth 13%	$8,720,821	$2,642,024

Qualified Small Business Stock (“QSB Stock”): Section 1202

How would you like to sell your interest in a closely-held company and not pay any tax on the gain?

- You may be able to if your interest is in the form of QSB Stock.
- Owners of QSB Stock can exclude gain on its sale or liquidation up to certain limitations.

3 Questions

- What is QSB Stock?
- What are the gain exclusion limitations?
- What if I want QSB Stock treatment, but my equity interest does not qualify?

What is QSB Stock?

- Purchased Upon Issuance from QSB. Stock purchased upon issuance directly from a C corporation that is a qualified small business in exchange for:
  - Money;
  - Property other than stock; or
  - Services other than underwriting services for the QSB Stock.

- Qualified Small Business as of the date of purchase.
  - The aggregate gross assets (by value) of the corporation have never exceeded $50 million.
  - Immediately after the QSB Stock purchase, the aggregate gross assets (by value) do not exceed $50 million.
  - The corporation meets the Active Business Requirements during substantially all of the taxpayer's holding period of the stock.

- 5 Year Rule. As of the date of the sale or liquidation, the taxpayer has held the stock for at least 5 years.

Active Business Requirements

- The corporation uses at lest 80 percent (by value) of the assets of the corporation in the active conduct of a qualified trade or business.
    - "Active Conduct" can include start up activities, payment of research and development expenses, and in-house research activities, even if there is no revenue.
- Qualified Trade or Business. In the Code, a Qualified Trade or Business is only described by omission and includes businesses that are not:
    - Professional services where the principal asset is the reputation or skill of 1 or more employees.
    - Financial businesses, such as banking, insurance, financial services, investing, etc.
    - Any farming business
    - Oil and gas extraction or any other production or extraction where percentage depletion is deductible, and
    - Hospitality business such as hotels, motels, or restaurants.

What are the Gain Exclusion Limits?

- For each year,
- For each QSB,
- The gain exclusion limit is
  - (a) $10 million, or
  - (b) 10 times
    - (i) the fair market value of the cash and property exchanged for the stock, plus
    - (ii) other cash and property subsequently contributed to the corporation.

Can a partnership be restructured to be a QSB?

Yes, several ways, for example:

- Partnership may be converted to a state law corporation.
- Partnership may elect to be treated as an association taxable as a corporation using Form 8832.
- Partnership assets may be contributed to a new C corporation.

Once assets are in the corporation, stock must still be held for 5 years.

What about an S corporation?

Yes, the S corporation assets can be contributed into a new C corp, owned by the S corp.

Can an S corp be converted to a QSB?

No, a corporation cannot be a QSB if it has ever been an S corporation.

Shouldn’t a business be put into QSB form as soon as possible to start the 5-year rule?

Perhaps, but consider the following scenario:

ABC Business Growth

	Value Per Owner	Maximum Exclusion Per Owner
Year 1 – Business Started	$100,000	$10 million
Year 3 – Business Growing	$1 million	$10 million
Year 5 – Business Maturing	$5 million	$50 million
Year 10 – Business Sold	$10 million	$50 million

If ABC is incorporated in Year 1 or Year 3, the maximum exclusion per owner would be $10 million. If ABC were incorporated in Year 5, the maximum exclusion per owner would be $50 million.

Multiplying Taxpayers

If we are going to be limited to $10 million per taxpayer, is it possible to increase the number of taxpayers to increase the number of $10 million gain exclusions?

Answer: Yes, in the case of a transfer of QSB Stock by gift, upon death, or from a partnership to its partner, the QSB Stock is still QSB Stock and retains its holding period.

Therefore, gifts to complex (non-grantor) trusts will allow the allowable exclusions to be increased.

Limitation on Number of Complex Trusts

The number of complex trusts is limited by IRC Section 643(f), which states that 2 or more trusts will be treated as 1 trust if the trusts have substantially the same grantors and beneficiaries and a principal purpose of the trusts is the avoidance of income tax.

For purposes of Section 643(f), spouses are treated as 1 person.

Private Placement Life Insurance

- The life insurance lobby is strong.
- IRC Section 101 provides that gross income does not include life insurance proceeds.
- This provision is broadly construed. The provision covers:
  - Term policies
  - Multi-year flat rate policies
  - Universal life insurance policies and whole life policies

- Economically, universal life policies and whole life policies are essentially term insurance policies combined with bank accounts, brokerage, accounts, insurance company managed portfolios, mutual funds, index funds, or Insurance Dedicated Funds (IDFs).

- Regardless of the insurance policy structure, most policies are purchased from the perspective of:
    - "How much do I have to pay to ensure that the policy never lapses, and the death benefit is paid?"
    - Or, "What is the least amount I have to put into a policy to fund it?"

- Policies based on this mindset are “retail products” purchased “off the shelf,” not individually negotiated.
- Consequently, a $10 million face value policy could be written as one $10 million policy, or 10 $1 million policies.
- Fees and commissions are paid out of the policy and based on a percentage of the face value of the policy or the premiums.

- Since all the growth and income derived from a policy is income tax free and just about any investment class is available, there is a second way that a policy may be viewed:

  > "How much death benefit must I purchase to be able to invest, say, $20 million into an investment account that is part of a life insurance policy so that it can grow free of income tax?"

- Let’s say you are not interested in the death benefit. Can you purchase a policy with a $1 death benefit and invest the $20 million into an insurance dedicated fund?
- That is where **Private Placement Life Insurance (PPLI)** comes in.
- The purchaser of PPLI overfunds the policy to the maximum extent allowable under the IRC in order to maximize the tax-free growth.

- PPLI is more like a personalized service.
- Commissions are usually structured as a fixed fee or sometimes at an hourly rate. And, commissions are paid by the purchaser to an “adviser,” not by the insurance company to a “broker.”
- The PPLI owner may choose between hundreds of IDFs and can change IDFs several times per year.
- Though the PPLI owner cannot choose actual investments, he or she can choose advisors and investment strategies.

- Benefits of PPLI include:
  - No tax on earnings on policy assets during life.
  - No tax on face amount paid at death.
  - No tax on earnings paid out after death.
  - No tax on amounts borrowed from the policy and spent during life, as long as the policy stays in force.

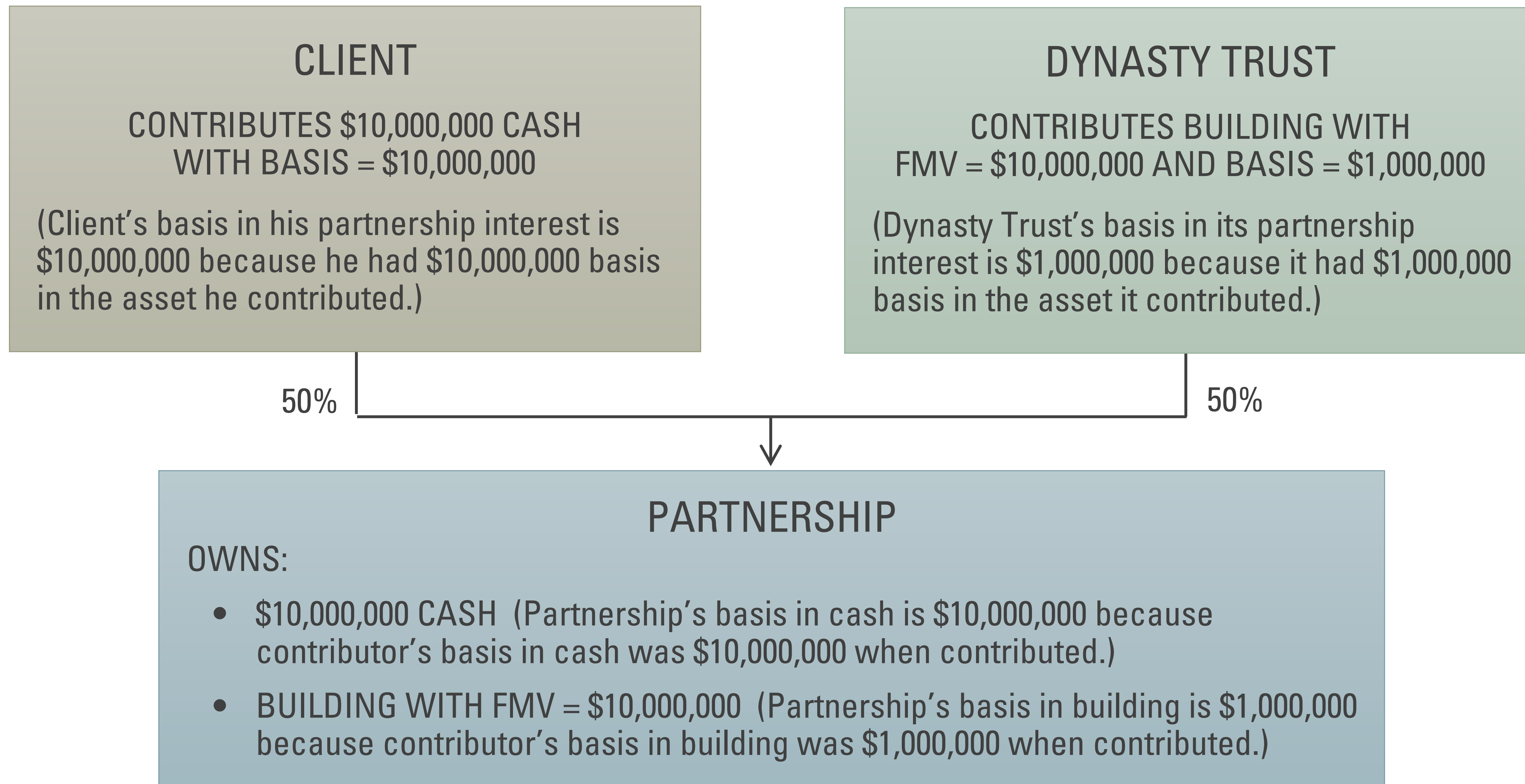
- Many clients have “legacy assets,” such as maybe a ranch they inherited 50 years ago. Let’s say it is worth $10 million and has a basis of $1 million. Can you put that ranch into the policy, have the policy sell it, and reinvest the cash, all income tax free?
- Oddly enough, even though the income tax law absolutely does not allow that, it is actually possible to achieve this goal.
- The law disallows it by making the transfer of an asset to an unrelated third party in exchange for some other asset or contractual rights a recognizable taxable exchange under both IRC Sections 61 and 1001.
- Transferring our appreciated ranch to the life insurance company and receiving in return a life insurance policy would be a taxable event.

Mixing Bowl Planning to Use an Appreciated Asset to Buy PPLI with No Taxable Gain

- A client is interested in the income tax benefits of owning PPLI and wants to sell an appreciated asset to purchase PPLI. But, he doesn't want to pay any capital gains tax on the sale of the asset.
- Example:
  - The client owns a commercial building with a fair market value of $10,000,000 and a basis of $1,000,000.
  - The client **borrows $10,000,000**, secured by the building.

- The client **gifts the commercial building to a Dynasty Trust**, which retains the $1,000,000 basis. (Note: The Dynasty Trust is a non-grantor trust, so it can later join with the client in creating a partnership that will be a true partnership for tax purposes.
- The client agrees to remain responsible for paying off the loan, so the trust isn't burdened with the obligation to pay off the loan.
- The client files a gift tax return to report the gift of the building, eating up $10,000,000 of his lifetime exemption.

- The client and the Dynasty Trust **enter into a Partnership Agreement**.
- The client contributes the $10,000,000 cash to the partnership in exchange for a 50% partnership interest. The client's outside basis is $10,000,000.
- The Dynasty Trust contributes the building to the partnership in exchange for a 50% partnership interest. The Dynasty Trust's outside basis is $1,000,000.


CLIENT
CONTRIBUTES $10,000,000 CASH
WITH BASIS = $10,000,000
(Client's basis in his partnership interest is $10,000,000 because he had $10,000,000 basis in the asset he contributed.)
DYNASTY TRUST
CONTRIBUTES BUILDING WITH
FMV = $10,000,000 AND BASIS = $1,000,000
(Dynasty Trust's basis in its partnership interest is $1,000,000 because it had $1,000,000 basis in the asset it contributed.)
50%
50%
PARTNERSHIP
OWNS:
• $10,000,000 CASH (Partnership's basis in cash is $10,000,000 because contributor's basis in cash was $10,000,000 when contributed.)
• BUILDING WITH FMV = $10,000,000 (Partnership's basis in building is $1,000,000 because contributor's basis in building was $1,000,000 when contributed.)

- The partnership uses the $10,000,000 cash to **buy PPLI**. The purchase should be structured where premiums are paid over time, so that the policy is not a modified endowment contract—a “non-MEC” policy.

PARTNERSHIP

OWNS:

- PPLI WITH FMV = $10,000,000 (Partnership’s basis in PPLI is $10,000,000.)
- BUILDING WITH FMV = $10,000,000 (Partnership’s basis in building is $1,000,000.)

- Note: Draft the partnership agreement and the trust so that the insured has no incidents of ownership over the policy.

- Seven years later, the **Partnership is liquidated**.
- The client receives the building, now with a basis of $10,000,000. The dynasty trust receives the PPLI, now with a basis of $1,000,000.

CLIENT	DYNASTY TRUST
BUILDING	PPLI
WITH FMV = $10,000,000 AND BASIS = $10,000,000	WITH FMV = $10,000,000 AND BASIS = $1,000,000

- Because the dynasty trust is a partner of the insured, we meet an exception to the transfer-for-value rule.

- The client **sells the building for $10,000,000**, which results in no gain, and repays the loan.
- The client essentially used the building to purchase the PPLI, without recognizing any gain.
- The trust holds the life insurance policy until the client dies.
- After the client's death when the dynasty trust receives the life insurance proceeds, there is **no gain or loss**, because life insurance proceeds are free of income tax as long as there has been no transfer for value.

What if the client dies within the 7 years?

- They would receive little or no basis bump and will owe capital gains tax when the building is sold, but, overall, they would come out better economically.
- Example:
  - Let's assume the $10,000,000 PPLI policy has a death benefit of $25,000,000.
  - The building is not in the client's estate at his death and doesn't receive the basis bump from $1,000,000 to $10,000,000. When the building is sold, capital gains tax will be due on $9,000,000 of gain. ($9,000,000 x 23.8% = $2,142,000).
  - But, the partnership receives the life insurance proceeds of $25,000,000. This is essentially a return of the $10,000,000 paid for the policy plus $15,000,000 of tax-free income.

Installment Sale Planning

Suppose you find yourself with a $10 million asset with $1 million basis and you would like to purchase a life insurance policy with the proceeds from the sale, but you do not want to wait 7 years before selling the asset.

Is there a way?

- Consider using installment sale proceeds, which can defer the gain.
- Note that this is a deferral, not a permanent elimination.

Here is how it works.

- **Action 1:** Sell the $10 million asset, or a portion of the asset, for fair market value to a related party in a taxable exchange for a 25-year installment note.

  The basis of the asset in the hands of the related party will be the fair market value purchase price.

  Under the installment sale rules, the gain is postponed until the principal payments are actually received, which will not occur for 25 years.

- **Action 2:** Payments may be interest only with a balloon payment due on the 25th anniversary. For May 2024, the minimum interest rate that the IRS will recognize is 4.55%.

- **Action 3:** The related party will wait at least 2 years before selling the asset to an unrelated party.

  The related party seller will recognize gain or loss based on the new basis of the purchased asset.

  Selling the asset before the 2-year mark would trigger gain on the original installment sale as of the date of the second sale.

- **Action 4:** The interest received by the first seller will be ordinary income.

  Because of the taxability of the interest income, for the installment sale math to work, the interest paid by the purchaser must be deductible.

Here are some investments that would allow the interest to be deductible:

- Taxable investment assets, such as publicly traded stocks and taxable bonds. In this case, the interest would be deductible to the extent of investment income.
- A trade or business in which the first purchaser materially participates.
- A passive trade or business in which the first purchaser does not materially participate, to the extent of passive income.
- A passive trade or business that will be disposed of within a reasonable time, even if there is not passive income. In this case, the interest will be deductible upon the disposal of the passive trade or business.

Note that if the second seller purchases life insurance directly with the proceeds from the later sale of the assets, it could result in the non-deductibility of the installment sale interest.

Assumptions

Investment: $10,000,000
Basis: $1,000,000
Rate of Return: 7% per year
Capital Gain Rate: 23.8%
Taxable Sale to Related Party on Day 1
Sale to Third Party After 2 years

	Without Installment Sale	Using Installment Sale as Deferral Mechanism	Difference
Total Assets After 25 Years	$35.5 million	$40.7 million	$5.2 million

Upstream Planning for Low Basis Assets

- If you have appreciated assets, you may need some “upstream” planning.
- For example, if an elderly parent has unneeded estate tax exemption, you could gift the assets to the parent so that the basis of the assets is increased upon the parent’s death.

- Example:
  - Client creates a trust benefitting the parent and gifts low-basis assets to the trust.
  - In drafting the trust, the client gives the parent a General Power of Appointment (GPOA) over the trust assets. The GPOA will cause the assets to be included in the parent's estate under Internal Revenue Code (IRC) Section 2041(a)(2).
  - In the parent's will, they exercise the GPOA and leave the assets to a trust for the client.
  - When the parent dies and the assets come back to a trust for the client, the assets will have a new stepped-up basis (under IRC Section 1014(b)(9)).

- **Caution:** IRC Section 1014(e) denies the basis step-up if the assets come back to the client or the client's spouse within one year. This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse with a trustee other than the client or client's spouse or (ii) to the client's child or a trust for the child's benefit.

- The outcome is the same if the trust is drafted so that if the GPOA is not exercised and the assets pass back to the donor child or to a trust benefitting the donor child. In this case, there would be no need for the parent to even exercise the GPOA.

Qualified Conservation Easements

What about getting a charitable deduction without giving anything away?

- Three kinds of real property interests qualify: entire interests; remainder interests; or perpetual conservation restrictions.
- To whom?
- For what purpose(s)?
- How long must it be for this purpose?
- What about retained mineral interests?

Charitable Remainder Trust Planning

- Prior to selling an asset, consider contributing it to a Charitable Remainder Trust ("CRT") and then having the CRT sell the asset. A CRT makes an annual payout to the donor, and at the donor's death, the remaining assets in the CRT pass to charity. The CRT is exempt from income tax, so it does not pay tax when it sells the asset. Instead, annual distributions from the CRT carry out income to the recipient, deferring the tax so it is paid gradually over the years as the CRT make distributions that spill out the income. Another tax advantage of the CRT is that, in the year it is created, the donor receives a charitable income tax deduction equal to the present value of the remainder interest that ultimately passes to charity.

- The annual distribution is either a fixed amount (a Charitable Remainder Annuity Trust or "CRAT") or a variable amount equal to a percentage of the CRT's assets valued annually (a Charitable Remainder Unitrust or "CRUT"). The most common version of a CRT provides that, at the death of the donor, the remaining principal passes to the named charity. Alternatively, the CRT can be structured to continue after the donor's death for the benefit of the donor's family members, and at the death of the named family members, the remaining principal passes to the named charity. When the CRT continues for family members, the present value of the interest passing to family members is subject to gift tax in the year the CRT is created.

- The annual annuity payout from a CRAT must be at least 5% of the initial value of the trust. The annual unitrust payout from a CRUT must be at least 5%, but no more than 50% of the CRT's assets, which must be valued annually. In both cases, the charity's remainder interest at the time the CRT is created must be at least 10% of the value of the assets contributed to the CRT.

- When a CRT is created, the donor receives a charitable income tax deduction equal to the present value of the charitable remainder interest. The present value of the remainder interest equals the fair market value of the assets contributed to the CRT, less the present value of the annuity or unitrust payments. To compute the present value of the annuity or unitrust payments, the Section 7520 rate, issued monthly by the IRS, is used as the assumed growth rate. The most advantageous time to create a CRT is when interest rates are high, as higher rates generate a larger value of the remainder interest.

- The CRT itself is exempt from income tax so it does not pay tax because of its transactions. A CRT can also receive the proceeds of a traditional IRA free of income taxes. However, when the beneficiary receives an annual payout from the CRT, the payout will be subject to income tax based on a “WIFO” (worst in, first out) tiering system. The tiering system carries out trust income to the beneficiaries, with the tax treatment being determined by the original character of the income when it was generated inside the CRT.

- When a CRT receives income, it is assigned to a category (e.g., ordinary income, capital gains, and non-taxable). Distributions to beneficiaries will carry out the "worst" income first, until all the income assigned to that category has been distributed. For example, if the CRT sells marketable securities in year 1, the capital gains realized upon the sale will be allocated to the capital gains category. Assuming the CRT has no ordinary income, distributions to the non-charitable beneficiary during year 1 and subsequent years will carry out capital gain, which will then be taxed to the beneficiary, until all of the capital gain has been distributed. After all the WIFO categories have been distributed, any remaining distribution is treated as a tax-free return of principal. Losses generated by the CRT's assets may offset the CRT's income and any excess can be carried forward to offset income in future years. Note that unrelated business taxable income ("UBTI") is subject to a 100% excise tax. Examples of UBTI include debt-financed income, operating business income, and certain types of real estate income.

- A CRT is often combined with an irrevocable life insurance trust ("ILIT"). The donors can use their income tax savings (generated by the charitable contribution deduction) and some of their extra annual cash flow (resulting from the income tax deferral) to pay premiums on life insurance owned by the ILIT. The ILIT can be structured to benefit their children, thereby "replacing" the assets passing to charity through the CRT.

  - Example: Husband and Wife, ages 65 and 64, own $3 million in highly appreciated stock that pays 3% in dividends each year ($90,000). They have a $200,000 basis in the stock and are in the 39.6% federal income tax bracket. Husband and Wife decide that, given their age, they should maximize their income during retirement. They also want to make a charitable contribution to their favorite charity. Husband and Wife have three options with respect to the stock—keep the stock, sell the stock and use the proceeds to diversify their investments, or utilize a CRT.

- If Husband and Wife merely keep the stock, they retain their $90,000 income stream, which will not increase unless the stock begins paying more dividends. Any charitable contribution that they make would potentially decrease this income stream.

- If Husband and Wife sell the stock, they will be required to pay a capital gains tax of over $666,400 (proceeds of $3 million, less $200,000 basis, multiplied by 23.8% capital gains tax rate and net investment income tax). Therefore, only $2,333,600 will be available to reinvest in a higher income-yielding investment. Assuming the investment earns 6% before taxes, the sales proceeds of $2,333,600 would produce about $140,000 in pre-tax income, or about $79,240 net of income taxes (39.6% income and 3.8% net investment income tax).

- If Husband and Wife create a CRT, they can contribute the stock to the CRT, and the trustee of the CRT can sell the stock tax-free and reinvest the proceeds. Therefore, the CRT would have a total of $3 million to invest (as opposed to the $2,333,600 that Husband and Wife would have to invest had they sold the stock themselves). Assume that the CRT earns 8% and pays out 5% annually in an annuity to Husband and Wife. Husband and Wife would receive a payment of $150,000 per year. In addition, in the first year, they would receive a charitable contribution deduction of $547,290 (equal to the present value of the charity's remainder interest).

- If Husband and Wife die in twenty years, the charity is projected to receive assets outright with a value of approximately $7,118,000.

- *Summary*: Husband and Wife transfer their stock, valued at $3 million, to the CRT. Husband and Wife receive an income tax charitable contribution deduction of $547,290 upon the transfer. Husband and Wife receive income from the CRT of $150,000 per year, totaling approximately $3 million during their lives (assuming a constant 8% growth rate and a survival period of twenty years). When Husband and Wife both die, the CRT assets of approximately $7,118,000 pass to the charity of their choice (assuming a constant 8% growth rate and a survival period of twenty years).

- It is important to note that CRTs are subject to the restrictions on self-dealing and excess business holdings applicable to private foundations. There can be significant taxes and penalties incurred if the CRT accidentally runs afoul of these rules.

Qualified Opportunity Zone Investing

- A Qualified Opportunity Zone Fund ("QOZ Fund") is an investment vehicle that invests in property or businesses in economically-distressed or low-income areas—an Opportunity Zone.
- The tax benefit for investing in Qualified Opportunity Zones was added to the tax code by the Tax Cuts and Jobs Act in 2017 in Section 1400Z.
- If you have a capital gain, you can defer recognizing the gain until 12/31/26 if you reinvest the proceeds in a QOZ Fund investment within 180 days. In addition, when you do recognize the gain, it's the lesser of the gain excluded or the fair market value of the QOZ Fund investment.
- If you hold the new QOZ Fund investment for 10 years, you can avoid paying tax on the gain when you sell the QOZ Fund investment by adjusting the basis in the interest to its fair market value.

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