Tax Workshop

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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- If the contribution is not withdrawn by the due date of the return, then Mr.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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Small Business Stock: Section 1202 Stock

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 1202 stock.

- Owners of 1202 stock can exclude gain on its sale or liquidation up to the greater of ten times the 1202 basis in the stock, or $10 million.

Is the stock you have or are looking to acquire 1202 stock?

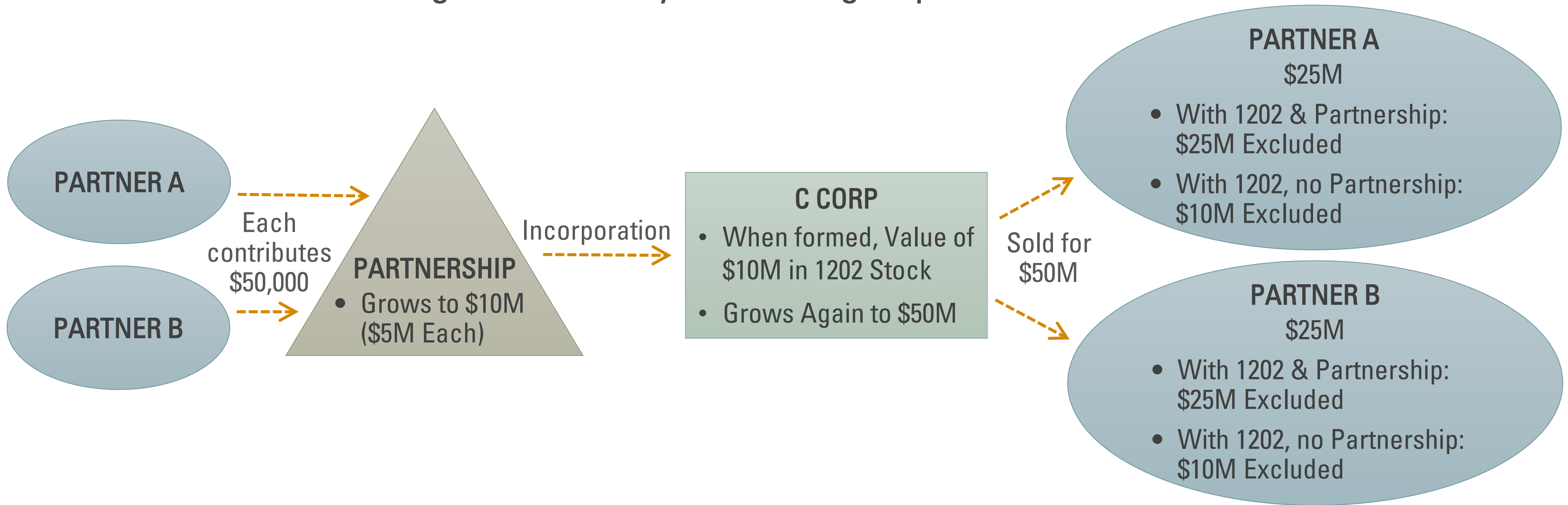
- Must be C corporation stock
- Must meet active business requirements, excluding professional services businesses
- Must hold for more than 5 years before sale or liquidation.
- Must have acquired the stock directly from company

Can an existing company be restructured to make interests qualify as 1202 stock?

Generally, yes, for a partnership (via 351 tax-free contribution). How?

- Conversion under state law
- Check-the-box (Form 8832)
- Merger
- Contribution
  - Assets over: Transfer assets to new C corp for stock, then liquidate transferring partnership.
  - Assets up: Partnership distributes all assets and liabilities to partners, then partners transfer assets and liabilities to C corp in exchange for stock.
  - Interests over: Partners transfer interests to new C corp in exchange for stock. The partnership terminates because there is now just one owner.

- The 1202 basis of property (not to be confused with the adjusted basis) contributed in exchange for 1202 stock is the fair market value of the property at the time of the contribution.
- The restructuring starts the 5-year holding requirement.

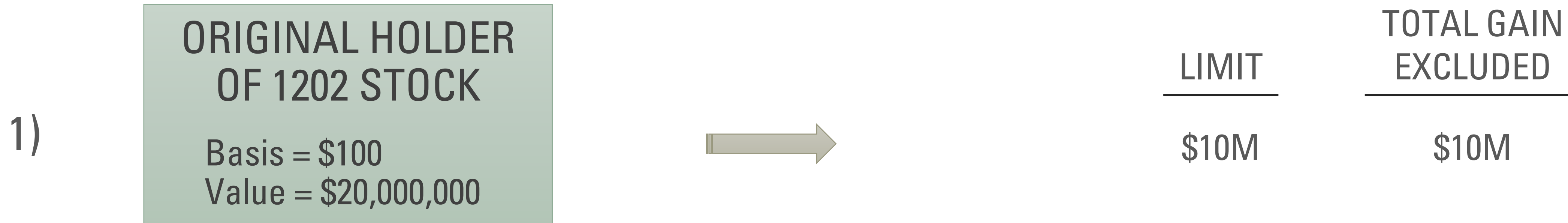


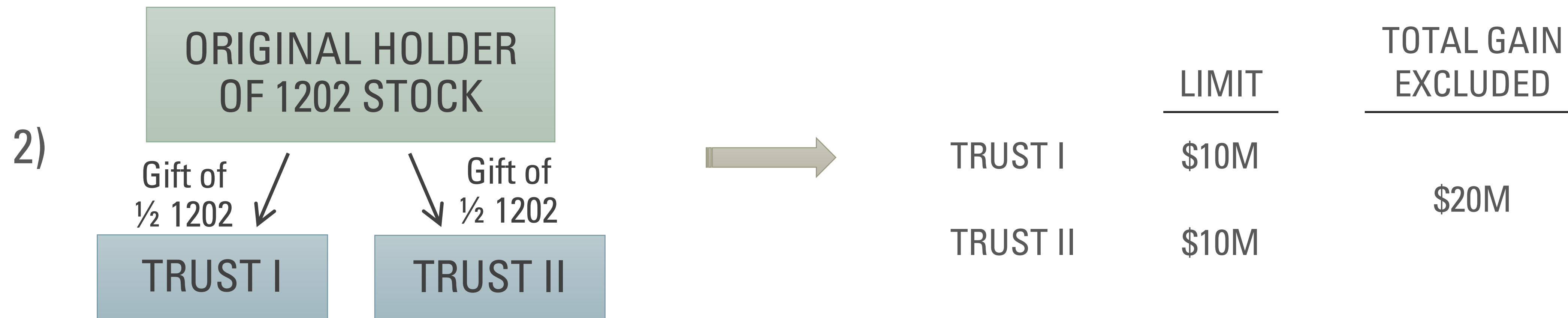
I have a company, and I want to use my entity to contribute to a corporation in exchange for 1202 stock. Can I do that, and will I be able to exclude gain, personally?

- Yes, as long as your company is not a C corporation and you:
  - Meet all 1202 eligibility requirements;
  - Hold the stock for more than 5 years; and
  - Held the interest in the entity on the date the entity acquired the 1202 stock until the sale.

Can I move 1202 stock into a trust? Into multiple trusts?

- Will it maximize/multiply the gain exclusion?





Small Business Stock: Section 1244 Stock

What if I sell at a loss or my stock becomes worthless? Can I do any better than taking a capital loss?

- Under some circumstances, you may be able to take an ordinary loss on stock sold at a loss.

What stock qualifies as 1244 stock?

- Stock issued by a small corporation (no more than $1 million total received in exchange for stock), at the time of the shareholder's investment.
- Stock issued for money or other assets (but not other stock).
- The corporation has more than 50% of income from sources that are not passive activities for 5 years (or less if a younger corporation) before sale.

How much is my potential benefit?

- For a married couple, up to $100,000 ($50,000 if single or married filing separately) of 1244 stock may be treated as an ordinary loss.
- Amounts over the limits may still be taken as capital losses.

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.

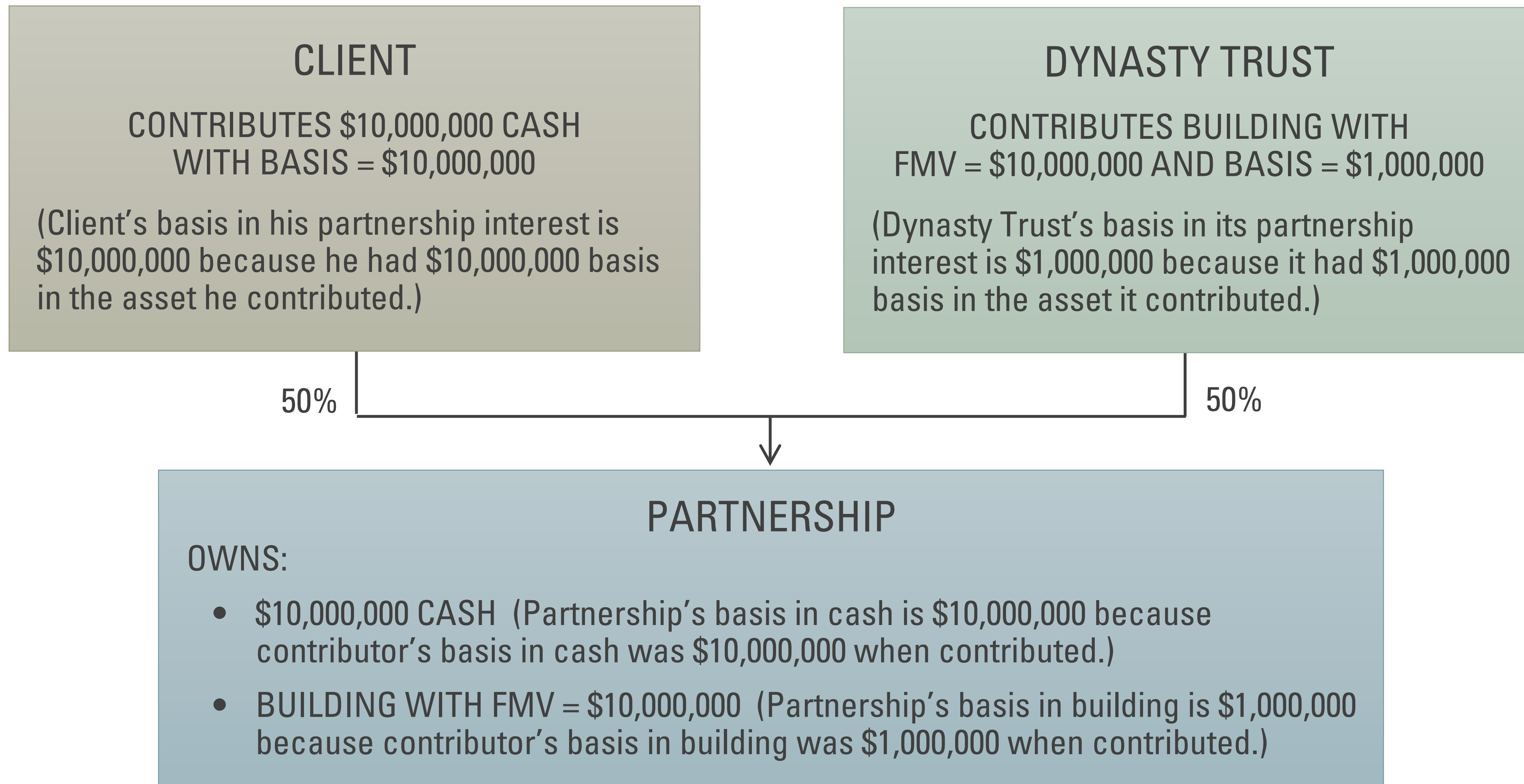
Mixing Bowl Planning to Use an Appreciated Asset to Buy PPLI with No Taxable Gain

- 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

BUILDING

WITH FMV = $10,000,000
AND BASIS = $10,000,000

DYNASTY TRUST

PPLI

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 Sales

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 August 2023, the minimum interest rate that the IRS will recognize is 4.03%.

- **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 seller first 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 trustee materially participates.
- A passive trade or business in which the trustee 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 purchasing life insurance directly with the proceeds from the later sale of the assets 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
After-Tax Internal Rate of Return	5.2%	5.78%	14.6% Improvement

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)).

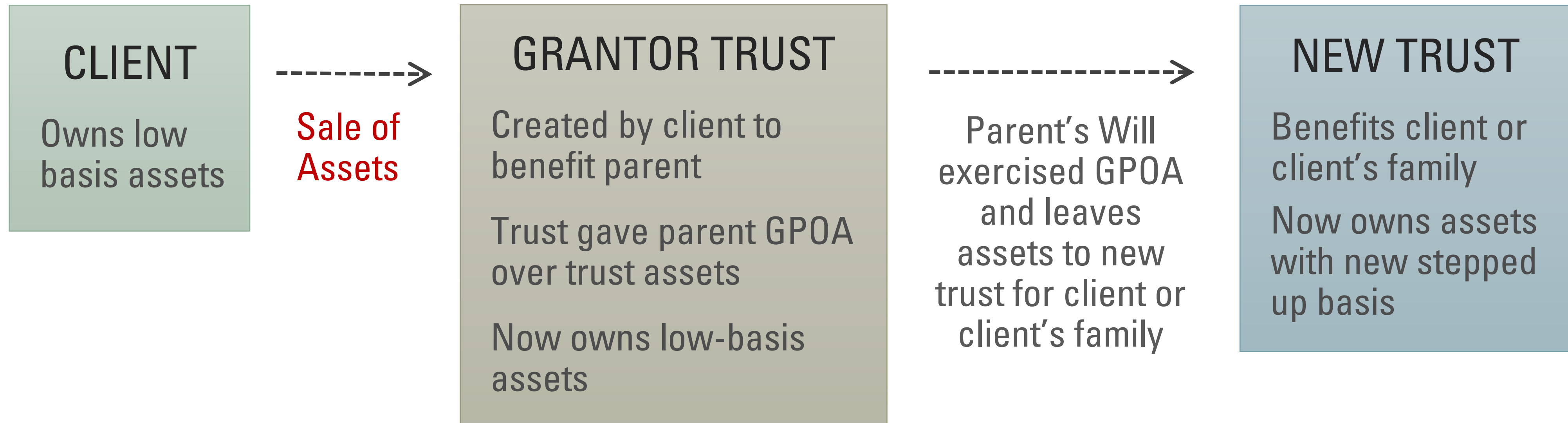
- **Caution:** IRC Section 1014(e) denies the basis step-up if the assets come back to the client or the client's spouse within one year. This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse with a trustee other than the client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

What if the client or the parent doesn't have enough lifetime exemption? Or, what if we don't want to use up their exemptions?

- Instead of the client making a **gift** to the parent, consider a **sale** to the trust.

- Example:
  - The client sells low-basis assets to a grantor trust in a bona fide sale, taking back a note secured by the assets. By selling instead of gifting the assets, the client's exemption won't be used up. And, because the trust is a grantor trust, there is no income tax on the sale.
  - When the parent dies, under IRC Section 2053(a)(4), the assets included in the parent's estate will be offset by the secured debt owing by the trust. So, the parent's estate would only increase by the amount of any appreciation on the assets between the date of sale and the date of death, less any interest paid on the note.



- The assets get a stepped-up basis, but the net increase to the parent’s estate is zero (assuming there was no appreciation between the date of sale and the date of death). Therefore, none of the parent’s exemption is used.
- We’ve obtained the same result as when we gifted the assets, but **neither the client nor the parent used up any exemption** to get it.

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 Giving

Donor Advised Fund versus Private Foundation, which is right for me?

- What are they?
- What kind of control can I retain over investments or distributions?
- How much can I deduct for contributions?
- How much regulatory complexity will I have to deal with?
- Can I remain anonymous?

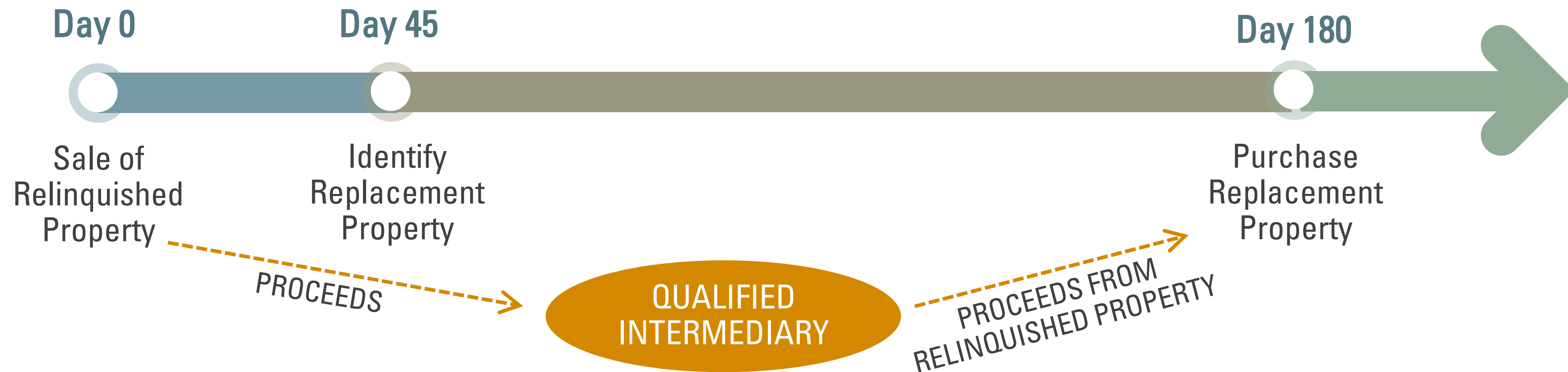
Like-Kind Exchanges (1031 Exchanges)

How do they work, and why might you want to do it?

- If you have investment real estate, no gain or loss will be recognized for tax purposes if exchanged for property of like kind.
- A replacement property may have better potential for a return.
- To simplify (or conversely, diversify) real estate holdings.

- Criteria:
  - Must be real property (since 2018)
  - Must be swap of properties
  - Properties must be for business or investment purposes
  - Properties must be of like-kind

- Mechanics:
  - Replacement property must be identified within 45 days of the transfer of the relinquished property, and the exchanging party has 180 days to acquire the replacement property.
  - Proceeds from the sale of the relinquished property must be transferred to a Qualified Intermediary, rather than the seller of the property, and the Qualified Intermediary transfers the proceeds to the seller of the replacement property.



  - Relinquished property of lesser value than replacement property?
  - Relinquished property of higher value than replacement property?

What about real property held in a partnership? What if the partners want separate treatment?

Plan ahead!