

South Plains Trust and Estate Council
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Creative Income Tax Strategies

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MARVIN E. BLUM is an attorney and CPA based in Fort Worth, Texas. He is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel.

Mr. Blum founded The Blum Firm, PC over 40 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-networth individuals.

Mr. Blum serves on the Editorial Advisory Committee for Trusts & Estates magazine, as Treasurer for the Texas Cultural Trust, and on the national TIGER 21 Board.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

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Theme of Today's Presentation

Quote from Judge Learned Hand:

“Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.”

Gregory v. Helvering US Court of Appeals for the Second Circuit- 69 F.2d 809 (2c Cir. 1934) March 19, 1934

Overfunding Your Roth IRA

- Having already successfully owned and operated 2 private equity funds, last year (Year 1) John and Christopher started a private equity fund called Fund 3.
- Each of the funds was structured so that John and Christopher each received a profits interest in each fund after the investors had received back their initial investment and a certain percentage return.
- John and Christopher each have a \$0 basis in their profits interest so they must pay a 20% capital gain tax on each dollar they receive from the profits interest.
- Funds 1 and 2 were very successful. John and Christopher were each paid \$5 million when Fund 1 and Fund 2 were liquidated, and each had to pay \$1 million in capital gains tax upon each liquidation.

- This year (Year 2), they sought out advice from Melvin Plummer, a well-known tax attorney at The Blum Firm, sometimes referred to as “The Taxes Hammer,” hoping to pay a lower capital gains tax.
- Without much thought, Melvin suggested they contribute their profits interest to their Roth IRAs, not realizing that was “bad.”
- It turns out that the fair market value of each profits interest at the time of the contribution was \$1 million.
- The entire contribution to the Roth IRA was considered an “excess contribution,” resulting in a 6% excise tax on both John and Christopher each year until the IRA made \$1 million in distributions to each of John and Christopher.
- In year 5, Fund 3 distributed \$5 million to each Roth IRA, then the Roth IRA distributed \$1 million excess contribution back to John and Christopher. Because both John and Christopher were well under the age of 59.5, the \$1 million distributions were subject to an additional 10% excise tax. Oh no!

- Following the distribution by each Roth IRA of \$1 million back to John and Christopher, each Roth IRA held \$4 million in Roth IRAs that had now been cleansed of the excess contribution.
- What a catastrophe! John and Christopher wanted to sue poor Melvin, so they went to another tax attorney so he could properly compute the damages caused by the silly attorneys at The Blum Firm.
- The other tax attorney thought long and hard and came back with a surprising answer. Melvin had actually saved John and Christopher a bunch of money!

- Here was his calculation:

	"Normal Taxes"	Roth IRA
Year 2 Contribution Penalty	\$0	\$60,000
Year 3 Contribution Penalty	\$0	\$60,000
Year 4 Contribution Penalty	\$0	\$60,000
Year 5 Contribution Penalty	\$0	\$60,000
Year 5 Distribution Penalty	\$0	\$100,000
Capital Gains Taxes	\$1,000,000*	\$0
Total Taxes and Penalties	\$1,000,000	\$340,000
Savings	\$0	\$660,000

- *without the Roth IRA, each receives \$5 million in Year 5 taxed as long-term capital gain at 20%, resulting in a \$1 million tax.

- As an added bonus, both John and Christopher got to keep the extra \$4 million inside their Roth IRAs growing income tax-free for the rest of their lives!
- John and Christopher were so happy that silly Melvin had accidentally saved them so much more money, they gave him a Honey Baked Ham at New Year's! Yay!!

Ladies and gentlemen, the moral of the story is obvious: It is better to be lucky than smart!

Qualified Small Business Stock (“QSBS”): 1202 Stock

Just the Facts:

- Client speaking to her CPA: “Hey, I just heard that if I own ‘Section 1202’ stock in a C corporation that I purchased after 2010, I do not have to pay any income tax when I dispose of the stock! Is this true and can I take advantage of it?”

Common Answers:

- 1) No, your company is an S corporation and is not eligible for Section 1202 treatment.
- 2) No, you bought your company from the prior owner, so your stock is not 1202 stock.
- 3) No, your entity is a partnership. Section 1202 treatment is only available for C corporations.
- 4) No, your company is worth more than \$50 million. Only a company with less than \$50 million in assets can issue Section 1202 stock.
- 5) Your stock is 1202 stock, but unfortunately, the assets you contributed were worth less than \$1 million when you and your spouse purchased the stock. Therefore, you can only exclude \$10 million of your expected \$50 million of gain.

#1. Your company is an S corporation and is not eligible for Section 1202 treatment.

- It is true that S corporation stock cannot ever become QSBS. An S corporation may, however, contribute its assets to a newly formed C corporation in a tax-free Section 351 exchange and take back QSBS stock. The 5-year timer would begin when the newly issued QSBS stock is issued.

#2. You bought your company from the prior owner, so your stock is not 1202 stock.

- It is true that QSBS must be originally issued directly by the corporation and that stock purchased from a third-party stock can never be QSBS. However, the corporation could elect to be an S corporation. It could then drop its assets down into a new C corporation owned by the S corp. The stock in the new C corporation may then qualify as QSBS and the client could receive a similar benefit. The 5-year time period, unfortunately, would have to restart.

#3. Your entity is a partnership. Section 1202 treatment is only available for C corporations.

- It is true that partnership interests are not stock and therefore cannot be QSBS. A qualifying business owned by a tax partnership, however, may be readily transferred to a C corporation in several different ways. At the entity level, the partnership may either convert to a corporation under state law, elect to be treated as an association taxable as a C corporation (filing a Form 8832), or contribute its assets to a C corporation in exchange for QSBS. Failing that, however, a partner may contribute his or her partnership interest to a C corporation, receiving back QSBS.

What if the other parties are not willing to have the partnership become a C corporation?

Am I out of luck?

- Not necessarily! I could transfer my interest in the partnership to a newly formed C corporation, taking back newly issued stock. This technique SHOULD work.
- All of the corporation's assets would then be partnership interests in a partnership that is engaged in active trade or business and all of the corporation's items of income or loss would be taken off of the K-1 issued by the partnership that engages in an active trade or business.
- However, there is absolutely no authority one way or another on whether a Qualified Small Business ("QSB") may look through a partnership to see whether the corporation is involved in an active trade or business. Section 1202(e)(5) specifically states that a QSB is entitled to look through a subsidiary corporation as long as it owns at least 50% of all classes of voting stock of the subsidiary or more than 50% of the value of all the subsidiary's outstanding stock.
- Without going into a long-winded discussion, it appears that a taxpayer owning C corporation stock would have an excellent argument that the corporation could look through a lower tiered partnership if the corporation owned at least 50% of the partnership interests.

#4. Your company is worth more than \$50 million. Only a company with less than \$50 million in assets can issue Section 1202 stock.

- It is true that the value of the assets contributed by your company to a new corporation cannot exceed \$50 million. But consider the following example:
- An LLC owns a business worth \$90 million and contributed an undivided 51% of its business to a newly created C corporation. The LLC and the new C corporation each then contribute their respective 49% and 51% interests to a new LLC, taxable as a partnership. The new C corp would have less than \$50 million immediately after contribution; therefore, that C corp would meet the \$50 million test.

#5. Your stock is 1202 stock, but, unfortunately, the assets you contributed were worth less than \$1 million when you and your spouse purchased the stock. Therefore, you can only exclude \$10 million of your expected \$50 million of gain.

- It is true that a taxpayer's gain may only be reduced by the greater of \$10 million or 10 times the fair market value of the assets contributed to the corporation. Also, for this purpose, a husband and wife are effectively considered one person for this limit.
- It is possible, however, to increase the number of shareholders through gifting shares of QSBS. Section 1202(h) specifically states that a donee will be deemed to have received the stock in the same manner as the donor and that the donee will be able to tack his or her holding period onto the donor's holding period.
- A married couple that owns QSBS and has four children could gift \$40 million of underlying value to four non-grantor trusts (one for each child) and the family could exclude \$50 million of gain. Assuming that the gift to each trust was discounted by 40%, the gift would be only \$24 million, would generate no gift tax, and would be GST exempt.

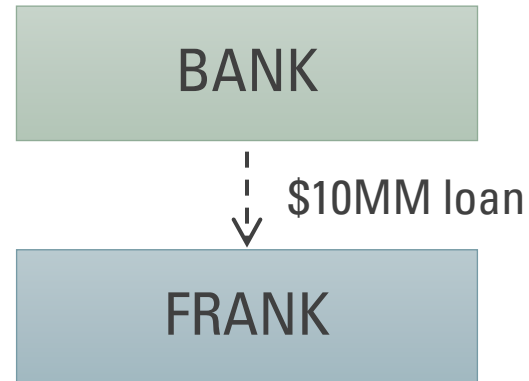
Private Placement Life Insurance

- Imagine there are no taxes... It's easy if you try... No audits or reporting...Investments growing to the sky... Ah, the immortal sentiments of John Lennon! You may say he was a dreamer..., but I think he was really looking forward to putting all of his money into **Private Placement Life Insurance** contracts.
- The life insurance lobby may be the strongest there is. You can literally put all of your investment funds into life insurance contracts and never pay a dime of income tax for the rest of your life! Wait, you say, “I have known people who thought they had a paid-up policy and then find out they had to put more in.”
- That is true because most of us purchase what I refer to as “retail” policies. These are policies purchased for the insurance benefits they provide. In these situations, the purpose of the purchase is to maximize the death benefit for the least amount of premium.
- In the private placement world, we want to invest a whole lot of cash but buy as little death benefit as we have to and still get the income tax benefits of owning life insurance.
- The policy purchaser may select the asset allocation of the policy investments but may not pick the investments themselves. Usually, the policy assets are invested in funds that are only available to life insurance policy holders. These funds are referred to as IDFs or Insurance Dedicated Funds.

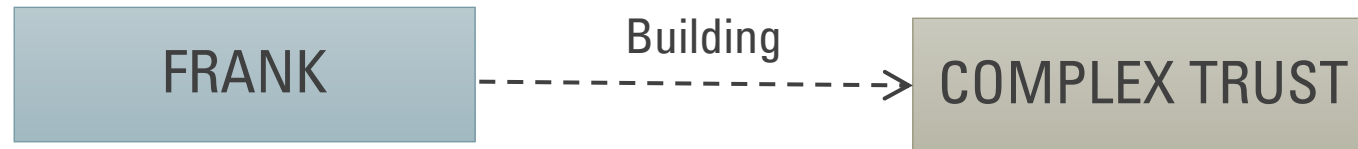
Mixing Bowl Planning to Use an Appreciated Asset to Buy PPLI with No Taxable Gain

- Melvin's client Frank heard about PPLI and has a great idea. He will use a low basis commercial building to purchase the PPLI without recognizing the gain... Right?
- Well, actually, no! Trading one asset for another is actually a taxable event.
- The building is worth \$10 million and has a basis of only \$1 million.

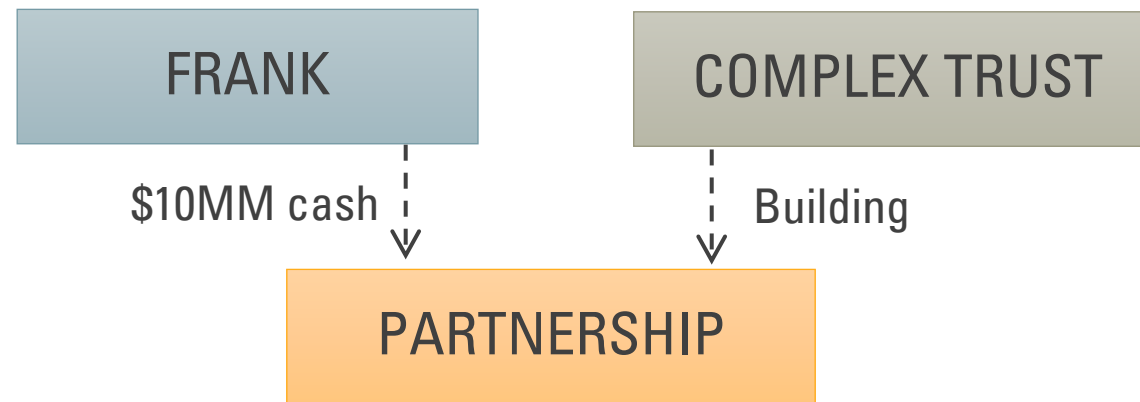
- **First**, Frank will borrow \$10 million from a bank, that is secured by the building.



- **Second**, Frank gifts the building to a complex (non-grantor) trust but retains the obligation to repay the loan.

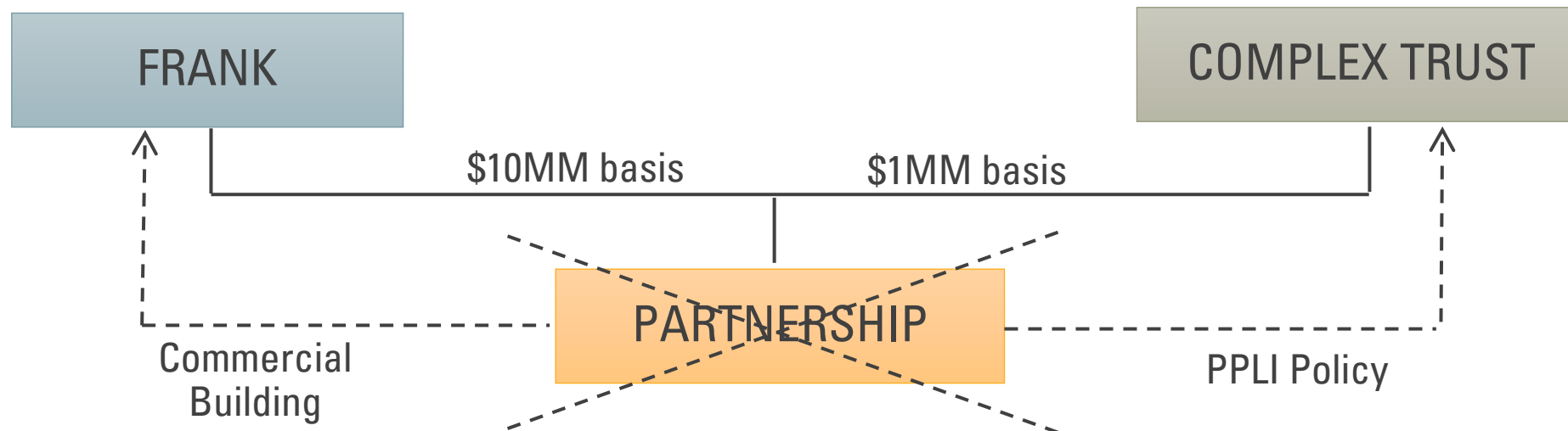


- **Third**, Frank and the new trust form a partnership. Frank contributes the \$10 million of cash, taking back a 50% partnership interest with a basis of \$10 million. The trust contributes the commercial building, taking back a 50% partnership interest with a \$1 million basis.

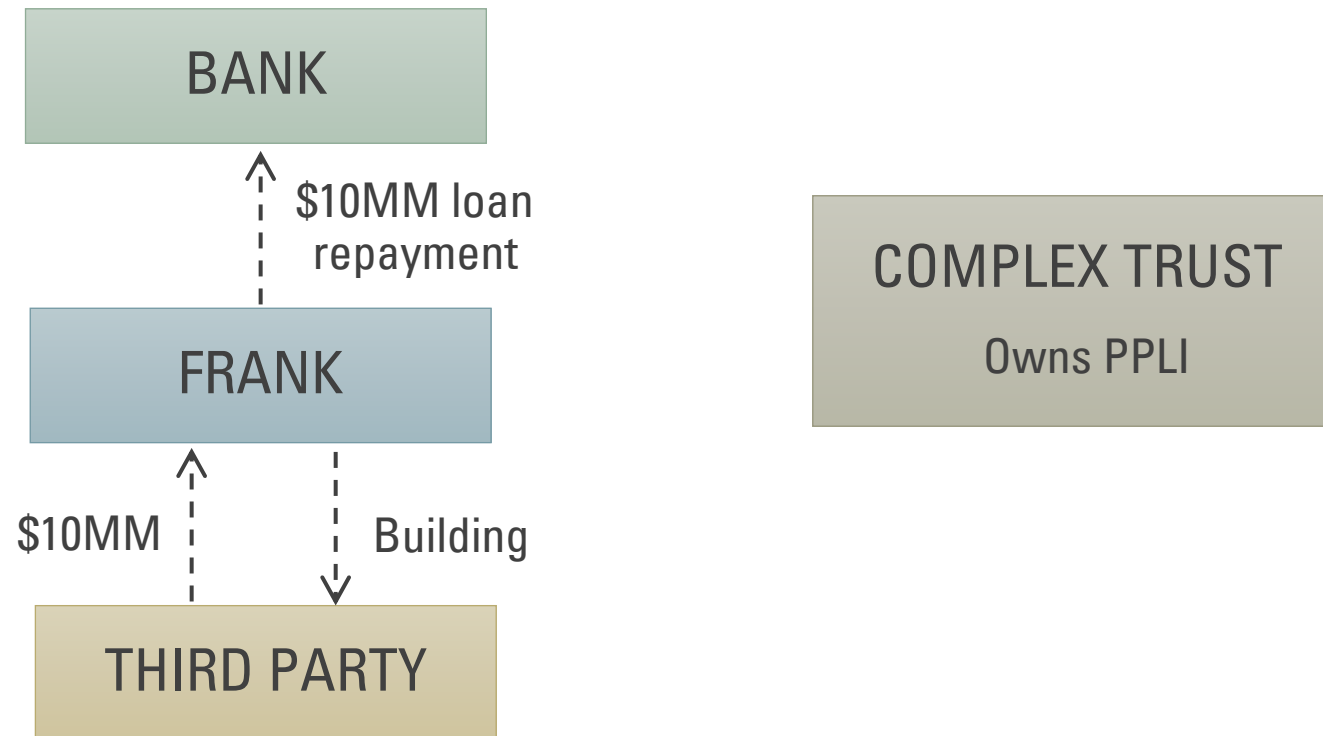


- **Fourth**, the partnership purchases a PPLI policy with the \$10 million of cash that Frank contributed.

- **Fifth**, after 7 years, the partnership is dissolved. The commercial building is distributed to Frank, taking Frank's \$10 million outside basis. The PPLI policy is distributed to the trust, taking the trust's \$1 million outside basis.



- **Sixth**, Frank sells the building to a third party for \$10 million and repays the bank loan. Since the building has a new basis of \$10 million, Frank owes no tax on the sale.



- **Seventh**, after the transaction, Frank has no interest in the PPLI policy. The complex trust's low basis in the policy is irrelevant because life insurance proceeds are not taxable.

FRANK

COMPLEX TRUST

Owns PPLI

Installment Sale Planning

Suppose you find yourself with a \$10 million asset with a \$1 million basis, but you do not want to wait 7 years before selling the asset. Also, you may not have any high basis assets, or at least none that you want to strip away.

Is there a way?

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

- Some years ago, Sally started a business selling beauty supplies, and it has really taken off.
- Her business is structured in two entities. Both are partnerships for tax purposes. One owns land and the building, but the other is the operating company that owns the goodwill with a value of \$10 million and a very low basis.
- She anticipates selling her business more than two years from now and asks you if there is a way to increase her low basis in the goodwill.

- Sally's CPA suggests that she sell an interest in the operating entity to a related party such as an S corporation or a non-grantor trust (let's assume a sale to the trust).
- The sale could be for a \$10 million interest-only installment note with a balloon payment due in 25 years. The seller recognizes no gain until the principal is repaid, 25 years later. The buyer (the trust) gets an immediate step-up in basis to \$10 million.
- The trust waits at least 2 years and then sells the business to a third party for \$10 million cash. The trust has a basis of \$10 million, so there is no gain. The \$10 million gain on the first sale (the installment sale to the related party) will remain tax-free for 25 years, deferring payment of the \$2 million tax and effectively giving her a \$2 million interest-free loan for 23 years.
- For the next 23 years, the trust pays interest only to Sally (income to her, deductible to the trust). The trust invests the \$10 million. No one pays the tax on the gain until 23 years later.

- Fun facts:
 - The “interest free” loan is generally limited to \$5 million per taxpayer (or \$10 million for a married couple who each own a portion of the asset being sold). If the installment note exceeds that limit, the taxpayer owes interest each year to the IRS on the excess.
 - The \$5 million limitation, however, does not apply to sales of personal use property or property used in the trade or business of farming.

- For example, Husband and Wife have a low-basis ranch or a highly appreciated home or vacation home in Hawaii or California. The installment method could be applied in those cases without paying any interest to the IRS, regardless of the size of the note.
- Note that an installment sale to a grantor trust (a commonly used “estate freeze” tool to shift future appreciation out of the estate) does not achieve the tax deferral described here because an asset that is sold by a grantor to his grantor trust is not considered to have changed hands, and the basis of the asset does not change.

What assets are suitable for an installment sale approach?

Generally, appreciated, non-depreciable, non-amortizable, capital assets that do not secure debt in excess of basis and whose gain will not be subject to ordinary income recapture.

Wow! What a mouthful!

Examples of Assets Suitable for Installment Sale Treatment:

- A business interest (closely held stock, LP or LLC Interests, etc.)
- A ranch or other unimproved real estate
- A personal residence or other personal use assets
- Mineral interests
- Wind rights
- Bitcoin or other crypto currency

Examples of Assets That Are Not Well Suited for Installment Sale Technique:

- Any property that is depreciable by the related party
- Appreciated Section 197 intangibles (purchased goodwill, purchased patents, etc.)
- Inventory
- Accounts receivable
- Assets that would be subject to depreciation recapture.

Recap of Steps

- **Action 1:** Sell the \$10 million asset, or a \$10 million portion of the asset, for fair market value to a related party in a taxable exchange for a 25-year installment note. (\$5 million if the client is unmarried.)
 - The basis of the asset in the hands of the related party will be the **fair market value purchase price**... NOT the basis in the client's hands.
 - Under the installment sale rules, the gain is postponed until the principal payments are actually received from the related party, which will not occur for 25 years.
- **Action 2:** Payments may be interest-only with a balloon payment due on the 25th anniversary. For December 2024, the minimum interest rate that the IRS will recognize is 4.53%.

- **Action 3:** For this technique to work the related party MUST 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 best, 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 by the related party. In this case, the interest would be deductible to the extent of investment income.
 - A trade or business in which the related party materially participates.
 - A passive trade or business in which the related party does not materially participate, to the extent of the related party's passive income.
 - A passive trade or business that will be disposed of within a reasonable time, even if there is not offsetting passive income. In this case, the interest will be deductible upon the disposal of the passive trade or business.
- Note that if the related party 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.*

Upstream Planning

At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase.

~Howard Zaritsky, nationally-known tax & estate planning attorney

- Jed was out shooting at some food. He missed but up from the ground came a bubbling crude...oil that is.

- Unfortunately, Jed's nephew Jethro lost all of Jed's money investing in Mr. Drysdale's bank.
- Fortunately, before the oil money was gone, Miss Jane started up Clampett's Oil Company, and it looks like Jed will be able to sell it for \$10 million in the next few years.
- Unfortunately, Jed's basis is only \$1 million.
- Jed goes to see Melvin.

- Melvin asks a few questions and finds out that Jed's father is still living (who knew?) and is in advanced stages of cancer.
- Melvin suggests that Jed contribute his equity interest in Clampett's Oil Company to a living trust and give his father a general power of appointment over the interest.
- If the father (who is competent) then appoints the Clampett Oil interest to a trust for "Jed and all his kin," then the ownership interest in Clampett Oil will receive a step up in basis to the fair market value on the father's death.

Basis Bump Swaps

- Years ago, Rancher Robert did some smart estate planning. He realized his ranch (worth \$1 million at the time) was located close to the Welsch Real Estate Development and would likely shoot up in value. To get the ranch out of his estate before it appreciated, Rancher Robert made a gift of the ranch to a Defective Grantor Trust for the benefit of his daughter Susie.
- Rancher Robert is now in poor health. The ranch is now worth \$5 million. Susie (herself, a smart CPA) realizes that at her dad's death, the ranch will not get a basis step-up because it is out of her dad's estate.
- Susie is happy about saving the 40% estate tax on the ranch, but wishes she could also get a basis step-up to \$5 million when Robert dies. She contacts Melvin the tax lawyer to see if she can have her cake and eat it too.

- Realizing Robert's days are numbered, Melvin gets to work fast. The Defective Grantor Trust contains a “swap power” allowing the Grantor (Robert) to remove an asset from the trust and replace it with assets of equal value.
- Robert transfers \$5 million cash to the trust and the trustee deeds the ranch back to Robert. Swaps and/or sales between a grantor and his grantor trust are ignored for income tax purposes, so there is no income tax on the swap.
- Rancher Robert dies soon after the swap, and the ranch gets a basis step-up to \$5 million. Moreover, the \$5 million cash in the trust escapes estate tax. Susie rewards Melvin with his favorite Nothing Bundt Cake, and together they have their cake and eat it too!

Qualified Conservation Easements (Getting a Charitable Deduction Without Giving Anything Away)

- Mr. King owns a ranch. It has been in his family for three generations. He cannot imagine a time when he would sell it and cannot tolerate the idea that his children or grandchildren would sell it.
- He is concerned about all of the new people moving into Texas, building houses and more freeways and shopping centers. Each year the developments creep a little closer. Land prices are escalating, and developers have been calling for some time. How can he keep his children and grandchildren from selling the ranch as soon as he is gone?

- His estate planner suggests that he grant a Qualified Conservation Easement (“QCE”) to a qualified charity. The estate planner said there were three aspects of a QCE that Mr. King would like:
 - Granting a QCE to a charity would allow Mr. King to obtain an income tax deduction with no cash outlay. The deduction would be equal to the fair market value of the ranch immediately before the granting of the easement, less the fair market value of the ranch immediately after the easement is granted.
 - The reduction in value of the ranch will decrease the fair market value of the ranch for gift and estate tax purposes.
 - The easement will reduce the value, thereby reducing the temptation for the children to sell the ranch after Mr. King has passed away, and also prevents the ranch from being developed. Mr. King will therefore be able to rest in peace.

- A QCE is a perpetual restriction on the use of real property. It can be for the protection of natural habitat for plants or animals, the preservation of land areas for outdoor recreation by the general public, the preservation of open space for the scenic enjoyment of the public, or the preservation of a historically important land area or structure.
- To be qualified, an easement must be granted to a governmental unit, a publicly supported public charity, or a supporting organization to a publicly supported public charity.

Charitable Remainder Trust Planning

- Dave owns a commercial building worth \$1,000,000 leased under a triple-net lease.
- Having purchased the building 15 years ago in a 1031 exchange and having successfully utilized cost segregation to accelerate his depreciation, Dave has no basis in the building and wants to sell now while cap rates are low, without getting a beat down on long-term capital gains.
- He goes to see Melvin for ideas, and Melvin brings up the idea of a Charitable Remainder Trust (“CRT”).

- Prior to a sale, Dave could contribute the building to a Charitable Remainder Trust with a 20-year term.
- Each year Dave would receive a payment equal to a fixed percentage of the fair market value of the trust assets. At the end of the term, all the remaining trust assets would pass to charities of his choice. The percentage of the trust assets that he could receive could be any percentage between 5% and 50%. The percentage selected would have to actuarially leave the trust with at least 10% of the assets contributed to the trust. For a 20-year trust, Dave could receive 10.87% of the fair market value of the trust.

- Melvin explained the income tax benefits of a CRT:
 - In the year Dave funds the CRT, he gets a charitable income tax deduction equal to the present value of the remainder interest that will one day go to charity.
 - CRTs themselves pay no income tax so the sale does not itself cause any income tax. Instead, CRTs keep track of their taxable income and the annual distributions carry out that income on a Worst-In-First-Out (“WIFO”) basis. Essentially, that means ordinary income, if any, is distributed first, followed by long-term capital gains.
 - This feature allows Dave to reinvest the sale proceeds without first paying the \$238,000 long-term capital gain. Also, the dividends, interest, and capital gains earned by the trust during the 20-year term are tax free to the CRT and only generate an income tax as distributions are made to Dave.
- Melvin then showed a spreadsheet showing the economic impact of Charitable Remainder Trust planning based on certain assumptions.

Assumptions

Asset Fair Market Value: \$1,000,000

Asset Basis: \$0

LTCG Rate: 23.8%

Assumed Going Forward Pre-Tax Growth Rate: 7%

Percentage of Growth Taxed Each Year: 33%

Assumed Blended Income Tax Rate: 25%

Distribution Percentage: 10.870%

Assumed Pre-Tax Growth Rate		7%	8%	9%
Assets in 20 Years	Without CRT	\$2,246,796	\$2,618,918	\$3,051,361
Amount to Charity		\$419,503	\$510,621	\$620,342
Value of Charitable Deduction		\$104,876	\$127,655	\$155,085
Total After Tax Assets		\$1,932,169	\$2,235,953	\$2,586,105
Total After Tax Assets	With CRT	\$2,182,054	\$2,571,948	\$3,029,033
% Improvement with CRT		13%	15%	17%
\$ Improvement with CRT		\$249,885	\$335,995	\$442,928

Qualified Opportunity Zone Investing

- On New Year's Eve of 2023, Ned received a hot tip that Nvidia's stock price was going to double within 3 months. So, on January 3, Ned bought 1,000 shares of Nvidia stock at \$475 per share and immediately entered a sale order at \$950. Sure enough, on March 25, Nvidia hit \$950 per share and Ned's shares were sold, locking in a nifty \$475,000 profit! Ned was on top of the world...until he found out that his "profit" is referred to by the IRS as "short-term capital gain" and comes with a 40.8% tax rate. One Hundred Ninety-Three Thousand Dollars! Ouch!
- Naturally, he calls his good friend Melvin, sometimes referred to as the "Taxes Hammer" and asks what to do. Melvin always has ideas. This time he suggests investing in a Qualified Opportunity Zone Fund ("QOZ Fund").

- Melvin knows that Ned really likes to invest in real estate investment funds and that Ned has a strong desire to invest in urban renewal. Melvin tells Ned that an investment in a QOZ Fund has two income tax advantages.
 - First, Ned can postpone his gain recognition until December 31, 2026, thus delaying the estimated tax payment, and when the time comes to pay it, Ned pays the tax on the lesser of the gain deferred or the fair market value of the new investment in the QOZ Fund on the recognition date.
 - Second, as long as Ned owns the QOZ Fund investment for at least 10 years, he can avoid paying tax on the gain by electing to adjust his basis in his QOZ Fund investment to the sale price of the QOZ Fund investment.
- Melvin cautions Ned that this tax benefit really only makes sense if the QOZ Fund investment makes money. Otherwise, the increased basis does not help him.

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