ATTORNEYS AT LAW
Marvin E. Blum*▪ Gary V. Post* John R. Hunter°▪ Steven W. Novak* Len Woodard▪
Amanda L. Holliday*▪ Lora G. Davis* Edward K. Clark°▪ Catherine R. Moon*▪
Laurel Stephenson* Laura L. Haley* Amy E. Ott▪ Rachel W. Saltsman
Christine S. Wakeman Kandice R. Damiano▪ Kerri G. Nipp Julie A. Plemons
Anna K. Selby Kelsey A. Brock Kent H. McMahan,* Senior Counsel

INCOME TAX PLANNING FOR HIGH WEALTH INDIVIDUALS

Wichita Falls Chapter of Texas Society of CPAs
May 20, 2014

by John R. Hunter

Written materials prepared by John R. Hunter and Anna K. Selby

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▪Certified Public Accountant Board Certified by the Texas Board of Legal Specialization in *Estate Planning & Probate Law °Tax Law
777 Main Street, Suite 700, Fort Worth, Texas 76102 Phone: 817.334.0066 Fax: 817.334.0078 TheBlumFirm.com
HOUSTON
AUSTIN

JOHN R. HUNTER
BIOGRAPHICAL INFORMATION

John R. Hunter, partner with The Blum Firm, P.C. with law offices in Fort Worth, Dallas, Houston, and Austin specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Mr. Hunter is an attorney and certified public accountant and is Board Certified by the Texas Board of Legal Specialization in Tax Law. He received his undergraduate degree in Economics *cum laude* and his Master's Degree in Accounting from Rice University. Mr. Hunter received his law degree *cum laude* from The University of Houston Law Center.

Mr. Hunter has practiced in both the private sector and with the government, where he represented the Commissioner of Internal Revenue before the United States Tax Court. He is a frequent speaker on estate planning and tax topics.

Mr. Hunter is consistently voted a "Texas Super Lawyer" (2004-2013) by *Texas Monthly* magazine – an honor given to only five percent of all attorneys in the state, and *Fort Worth, Texas* magazine has recognized him as one of Tarrant County's "Top Attorneys" in both Tax Law (2009-2013) and Probate, Estates, and Trusts (2010-2013). Mr. Hunter was also honored as Professional of the Year for 2009 by the Community Foundation of North Texas. He currently serves as an Officer of the Fort Worth Business and Estate Council and as Vice-Chair of the Professional Advisor Outreach Committee of the Community Foundation of North Texas.

Mr. Hunter and his wife, Carmen, live in Fort Worth with their three children.

INCOME TAX PLANNING FOR HIGH WEALTH INDIVIDUALS

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I. TAX PLANNING THROUGH CHARITABLE GIVING

A. OUTRIGHT CHARITABLE CONTRIBUTIONS DURING LIFE

An individual can make a contribution of cash or property outright to a charity and receive a charitable contribution deduction on his[1] tax return, so long as certain requirements are satisfied. The contribution must be voluntary, the contribution must be made to a qualifying charity, and the donor must not receive value from the charity in return. An exception to the last requirement is that the donor may receive nominal value from the charity and still qualify for the charitable contribution deduction.

1. Gifts of Cash. A donor may deduct, as a charitable contribution, the amount of cash gifted to a charity.

2. Gifts of Property. In general, a donor may deduct the fair market value of property contributed to a charity. (See Section B, below, for restrictions.)

3. Quid Pro Quo Gifts. If the donor receives value (such as property or services) from the charity in exchange for his contribution, the donor must reduce his charitable contribution deduction by the fair market value of the property or services he received. Charities generally can provide this value to the donor.

B. SPECIAL RULES REGARDING ALLOWABLE CHARITABLE CONTRIBUTION DEDUCTION

The IRS has imposed certain restrictions on the charitable contribution deduction permitted to be taken by a donor based on (i) the type of property contributed and (ii) the type of entity to which the property is contributed. The applicable rules are complicated; they are summarily discussed below.

[1] As used in this document, the masculine, feminine, and neuter genders each include the others unless the context requires otherwise.

1. Contributions of Cash. As explained above, a donor may deduct the amount of cash contributed to any type of charity up to certain maximums.

   However, for tax purposes, it may be more advantageous to contribute appreciated property rather than cash. For example, if a taxpayer donates stock to a public charity that would have resulted in a long-term capital gain if it had been sold instead, the taxpayer may claim a charitable deduction for the fair market value of the property and is not required to pay tax on the appreciation. However, limitations also apply to donations of appreciated property as explained below.

2. Contributions of Property. Depending on the type of property contributed to a charity, the donor's deduction may either be limited to his basis in the property or be equal to the property's fair market value.

   a. Deduction Limited to Donor's Basis. In the following situations, the donor's charitable contribution deduction is limited to the donor's adjusted basis in the property contributed:

      - Appreciated property that would trigger ordinary income or a short-term capital gain if sold. This is generally a capital asset that has appreciated in value but has been owned by the donor for less than a year.

      - Appreciated tangible personal property contributed to a public charity or private operating foundation for a use unrelated to the charity's exempt purpose.

      - Appreciated property, other than "qualified appreciated stock," contributed to a private non-operating foundation. Qualified appreciated stock is stock that has been held for more than one year and for which market quotations are readily available on an established securities market.

   b. Deduction Equal to Property's Fair Market Value. In the following situations, the donor's charitable contribution deduction is equal to the property's fair market value:

      - Property that would trigger a loss if sold. This rule applies when a depreciated piece of property is donated to any type of charity. The deduction is limited to the fair market value, which is actually lower than the donor's adjusted basis.

- Appreciated tangible personal property contributed to a public charity or a private operating foundation for a use related to the charity's exempt purpose.

- Appreciated real property or intangible personal property (such as stock) contributed to a public charity or a private operating foundation, provided that the asset has been owned for at least one year.

- Qualified appreciated stock contributed to a private non-operating foundation. Certain additional restrictions apply depending on the amount of stock contributed.

c. Donations of Vehicles. Although prior law allowed a donor to deduct the fair market value of automobiles, boats, and small airplanes contributed to charity, new laws provide that a donor may only deduct the amount of gross proceeds the charity actually receives when it sells the automobile, boat, or airplane.

d. Donations of Partial Interests. Subject to several exceptions, Section 170(f)(3) of the Code disallows a deduction for a charitable contribution (not made by transfer in trust) of a partial interest in property. For purposes of Section 170(f)(3), a partial interest is any interest in property that consists of less than the donor's entire interest in the property. A contribution of the right to use property is considered a gift of a partial interest.

Example: Donor owns a 6-story office building. During 2013, Donor allows a historical society, a charitable organization, to use the top floor of the office building rent-free. The organization uses the space to administer its exempt programs and for a library. Donor's contribution of the use of the building is a nondeductible gift of a partial interest.

When it comes to real estate, there are usually many partial interests in a single parcel of land, including the right to graze livestock and the right to extract minerals. Accordingly, a donor must convey all of his undivided interest in real estate, including any mineral interests or grazing rights, to a charitable organization in order to receive the charitable deduction.

However, the rule disallowing a deduction for a charitable contribution (not made in trust) of a partial interest in property does not apply to a transfer of less than the entire interest if it is a transfer of (a) a remainder interest in the taxpayer's personal residence or farm, (b) an undivided part of the taxpayer's entire

interest in property (subject to other restrictions as set forth in Section I.B.3 below), or (c) a qualified conservation contribution.

3. Pension Protection Act of 2006 Provisions - Undivided Interests in Tangible Personal Property. Until the enactment of the Pension Protection Act, a charitable deduction was allowed for gifts of an undivided fractional portion of a donor's entire interest in tangible personal property (such as an undivided interest in a piece of art). If the gift was used in a manner related to the exempt purposes of the donee, the deduction was based on the relevant fraction of the entire fair market value of the property at the time of the contribution. If the donee's use was unrelated, the deductible amount was limited to the donor's basis in the property. The Pension Protection Act significantly restricted these deductions to eliminate perceived abuses.

   a. All Interests Owned by Donor or Donee. All interests in the item must have been owned by the donor or the donor and the donee immediately before the contribution.[2] In other words, there can be no third party owners - only the donor and the donee charity. An exception exists if all persons who hold an interest in the property make proportional contributions of an undivided portion of the entire interest they hold.[3] This rule applies for gift tax as well as income tax purposes.

   b. Deduction for Future Gifts of Undivided Interests in the Same Property. If the use of the property is related to the donee's exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on future gifts of additional undivided interests in the same property (and the gift must be made to the same donee or else no deduction is allowed under the first new rule described above). In that situation, the fair market value of any additional contribution is determined by using the lesser of (1) the property's fair market value at the time of the initial fractional contribution, or (2) the property's fair market value at the time of the additional contribution.[4] Therefore, there will be no increased deduction allowed attributable to increases in the fair market value of the entire property after the time of the initial fractional gift. (However, consistency is not required where the property decreases in value after the initial gift.)

   This rule applies for estate and gift tax as well as income tax purposes.[5] This is critically important. For example, if an individual makes a gift of a fractional interest in property, and

[2] IRC § 170(o)(1)(A).
[3] IRC § 170(o)(1)(B).
[4] IRC § 170(o)(2).
[5] IRC §§ 2055(g), 2522(e).

leaves the balance of the property to the charity at the individual's death, there can be a mismatch of estate inclusion and allowable deduction: the individual's remaining undivided interest would be included in the estate at its full value, but the estate tax charitable deduction would be allowed based on the value of the property at the time of the initial contribution.

c. Recapture of Deduction and Recapture Penalty. A recapture of the income or gift tax (but not estate tax) charitable deduction will occur where the following events have not occurred within ten years of the initial fractional gift or the donor's earlier death:

- If the donor does not contribute all of the remaining interest in the property to the donee (or if the donee is no longer in existence, to another Section 170(c) organization); and

- If the donee has not (a) had substantial physical possession of the property, and (b) used the property in a use related to the organization's exempt function.[6]

Accordingly, a gift of a fractional interest in property that is unrelated to the charity's exempt function can still be deducted initially based on the donor's basis (but not the full fair market value). However, if the property is not given a related use within the ten year or earlier death period, the charitable deduction (plus interest) is recaptured. There is also a recapture penalty of 10% of the amount recaptured.

4. Pension Protection Act of 2006 Provisions - Tangible Personal Property Deductions. A charitable deduction for contributions of tangible personal property exceeding $5,000 must be reduced or recaptured if the donee sells the property within three years of the contribution.[7] If the sale occurs within the tax year of the contribution, then a reduction in the charitable contribution deduction is made to basis, and if the sale occurs after the first tax year but within three years, then the above-basis portion is recaptured. An exception to this rule exists if a certified statement by the donee is made stating that the property was for the organization's exempt purpose, how it was used for such purpose, or why it became impossible to do so.

The Pension Protection Act also added a penalty provision ($10,000) to the Code designed to penalize donees for falsely identifying donated property as having a use related to their exempt purpose. The penalty is in addition to any criminal penalty that may also be applicable.

[6] IRC §§ 170(o)(3)(B), 2522(e)(3)(B).
[7] IRC § 170(e)(7)(A).

5. Annual Percentage Limitations. Another limitation that the IRS imposes on charitable contribution deductions is that the deduction can be no larger than a certain percentage of the donor's "contribution base" (the contribution base is equal to the donor's adjusted gross income). In other words, depending on the specific contribution, the donor can only offset a certain percentage of his income with a charitable contribution deduction.

   a. 50% Limitation. Generally, the donor's charitable contribution deduction is limited to 50% of the donor's contribution base when (i) cash or (ii) property is contributed to a *public charity* or a *private operating foundation*.

   b. 30% Limitation. Generally, the donor's charitable contribution deduction is limited to 30% of the donor's contribution base when (i) cash or (ii) property that would trigger a loss or ordinary income if sold is contributed to a *private non-operating foundation*.

   c. 20% Limitation. Generally, the donor's charitable contribution deduction is limited to 20% of the donor's contribution base when property that would trigger a long-term capital gain if sold is contributed to a *private non-operating foundation*.

Any excess charitable contribution deduction that cannot be taken in one year may be carried forward five years for the purpose of deducting the excess contribution on a future income tax return.

6. Substantiation Requirements. Under the Pension Protection Act, the donor must be able to substantiate his charitable contributions. Specifically, the donor must obtain a written acknowledgment from the charity for all contributions exceeding $250. If the donor is claiming a deduction with respect to property (other than cash, inventory, or marketable securities) that exceeds $5,000, the donor must obtain an appraisal but need not attach it to his tax return. However, if the donor contributed art that is valued at $20,000 or more, he must obtain an appraisal and attach the appraisal to his tax return.

7. Tax Deduction Deadlines. In order to be deducted in a certain year, contributions of property and cash must be received by the charity no later than December 31 of that year. However, if a cash gift is made by check or a credit/debit card, the donor need only mail the check or use the credit/debit card by December 31 in order to claim the charitable contribution deduction for that year.

Note: The above rules and limitations generally apply to all charitable gifts made during life whether outright or in another form discussed below.

C. CHARITABLE BEQUESTS AT DEATH

An individual may also make a donation to a charity at the individual's death through his Will. The donor's estate can then take a charitable contribution deduction equal to the fair market value of the gift (but no greater than the value of the donor's taxable estate for federal estate tax purposes). If the donor dies with a taxable estate (an estate with more than $5.34 million in assets in 2014), this would effectively reduce any federal estate taxes owed at the donor's death, which are assessed at a 40% estate tax bracket.

D. USING AN IRA TO FUND CHARITABLE GIFTS AND BEQUESTS

If an individual plans to make a charitable gift at his death, naming a charity as the beneficiary of an IRA or other retirement plan can maximize the amount of money the charity receives, as well as the amount of money that the individual's family receives.

In addition, naming one's spouse as the primary beneficiary and a qualified charity as the secondary beneficiary of a retirement plan (or, in the alternative, the charity as the primary beneficiary) provides an individual with an opportunity to benefit his charity of choice with a minimal impact on heirs.

IRAs and retirement plans are attractive vehicles for leaving assets to a charity because of the double taxation imposed on IRAs at death. Estate taxes are paid by the participant's estate on death, and income taxes are paid by heirs as withdrawals are made. This double taxation makes retirement plans extremely poor vehicles for passing wealth to one's descendants.

When an individual names a charity as the beneficiary of an IRA, the IRA is still fully includable in his taxable estate, but the estate receives a charitable deduction equal to the amount passing to the charity. Because the charity will not be required to pay income taxes on IRA withdrawals, the charity ultimately pockets the entire IRA. The impact on the individual's heirs is minimized by the fact that had they been named beneficiaries of the IRA, estate taxes and income taxes could have left them with as little as 20 cents on the dollar.

> *Example*: Donor owns a $100,000 IRA. His wife predeceased him, and he has two children whom he names as beneficiaries of the IRA. If Donor dies with a taxable estate, his $100,000 IRA could be subject to estate taxes as high as $40,000 ($100,000 x 40% estate tax rate). Therefore, only a net amount of $60,000 from the IRA would pass to his children. Distributions that they take from the IRA to pay the estate taxes will be subject to income taxes, as will distributions they take for their benefit during their lives. The income taxes generated by these distributions could be as high as $39,600 ($100,000 x 39.6% income tax rate). As a result, Donor's children could receive as little as $20,400 net of taxes from the $100,000 IRA ($100,000, less $40,000 in estate taxes, less $39,600 in income taxes). (*Note*: This example ignores the "income in respect of a decedent deduction" due to its limited benefit as an itemized deduction.)
>
> Instead, Donor could name his favorite charity as the beneficiary of the IRA. His estate would receive a charitable contribution deduction in an amount equal to the IRA, and the

charity would receive the full $100,000. As the charity takes distributions from the IRA, it will not pay income taxes and will ultimately receive the full amount of the IRA.

Note: Because of the uncertainty of how much will actually remain in an individual's IRA at the time of death, if a specified amount is desired to pass to charity, the individual should include a provision in his Will leaving the charity of choice the desired amount, reduced by any amount passing to the charity by beneficiary designation on the individual's death.

E. LIFE INSURANCE

There are multiple options available when using life insurance as a means of making a charitable contribution. An individual may purchase a life insurance policy, naming his charity of choice as the beneficiary and the owner. The individual may then take a charitable contribution deduction against his income taxes for the fair market value of the life insurance policy and for the premium payments made by the donor each year.

A second option is for the individual to name the charity as the beneficiary of all or a portion of any life insurance policy currently in place or purchased in the future. This allows the individual to make a significant charitable contribution upon the individual's death and qualifies for an estate tax charitable contribution deduction. However, merely naming a charity as the beneficiary of the policy does not allow the individual to take a charitable contribution income tax deduction for the premium payments.

A third option is for the individual to name the charity as the irrevocable beneficiary of a life insurance policy. Doing so will prevent the individual from ever removing the charity as a beneficiary of the policy without the charity's consent. The individual may also be required to obtain the charity's consent before modifying the terms or amount of coverage. This option will not permit the individual to take a charitable contribution deduction during his life, but will permit the individual's estate to take a charitable contribution deduction upon the individual's death.

Life insurance can also be used to fund a "*wealth replacement trust*." For example, if a person planned on leaving $5 million to his children at his death, but also was charitably inclined, he could create an irrevocable life insurance trust (an "ILIT") and fund it with a $5 million life insurance policy. If the ILIT is structured correctly, the proceeds would not be included in his estate and pass entirely to his children as their inheritance. He would then be free to leave his entire estate to charity and would pay no estate tax.

Finally, more advanced techniques use flexible life insurance policies in conjunction with a charitable trust such as a charitable remainder trust (described in Section F below) to produce benefits for both the charity and the family of the donor.

Example: Bob and Jane, wanting their favorite charity to ultimately receive $1 million, create a charitable remainder unitrust (a "CRUT") that is designed to pay Jane up to 6% of the CRUT's assets annually (limited by the CRUT's income) in the event Bob dies prematurely, or Bob and Jane's children for five years if they both die prematurely.

Following an initial gift from Bob and Jane of $10,000, the CRUT purchases two insurance policies. The first is a $500,000 face value, 15-year term policy with a provision for return of premiums if Bob lives for 15 years with no terminal illness, as well as a provision for an acceleration of benefits if Bob is diagnosed with a terminal illness. The second policy is a second-to-die universal life policy, also with a face value of $500,000. The gifts by Bob and Jane to the CRUT to allow the CRUT to pay the premiums on both policies will result in a partial charitable deduction for Bob and Jane, with the amount of the deduction increasing as they get older.

If Bob dies within 15 years, the first policy will pay the trust $500,000, and the CRUT will pay Jane up to $30,000 per year for the rest of her life. If both Bob and Jane die, then their children will split an annual payment of $60,000 each year for five years. If Bob lives longer than 15 years, then CRUT would receive a refund of the premiums paid for the first policy and could invest those funds to pay the premiums on the second policy. Of course, at the end of the CRUT term, the charity would receive the balance of the CRUT assets, which would likely be somewhere over $1 million if Bob died prematurely or $500,000 if he lived to his normal life expectancy.

An additional technique involves making a large initial gift to a charitable remainder trust and then funding an irrevocable life insurance trust with the income tax savings, which is described in Section F below.

F. CHARITABLE REMAINDER TRUSTS

When an individual creates and funds a charitable remainder trust (a "CRT"), income from the trust is distributed back to the donor (either a fixed amount (a "CRAT") or a variable amount (a "CRUT")), and 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 (for either their lives or a fixed period of time), and at the death of the named family members, the remaining principal passes to the named charity.

Tax Advantages of a CRT. When a CRT is established, the donor receives an income tax deduction for the value of the remainder interest (with special rules applying to property with a basis that is lower than the property's fair market value). If appreciated assets are contributed to a CRT, the CRT can sell them with no tax due at the time of the sale. This provides an excellent opportunity to convert low income-producing assets to cash without a capital gains tax. In many plans, taxpayers use the savings to purchase life insurance (to be owned by an irrevocable trust for the benefit of family members) to "replace" the assets going to charity at the donor's death.

When CRTs are Beneficial. The best time to create a CRT is when interest rates are high and the donor owns an asset that is highly appreciated. When interest rates are high, it is easier to meet the requirement that the CRT have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the CRT. Because a CRT can sell property without income tax consequences (as noted below), a CRT provides the most benefit when a donor contributes property with a high fair market value but with a low income tax basis.

Additionally, if capital gains rates are increased, CRTs may become even more effective for donors with highly appreciated assets.

Income Tax Consequences. As noted above, the donor receives an up-front charitable contribution deduction equal to the value of the remainder interest when the CRT is created. The CRT is exempt from tax, so it does not pay capital gains tax or income tax as a result of its transactions. When the donor receives (or other family members receive) annual distributions from the CRT, the distributions may be subject to income tax based on a tiering system. The tiering system carries out trust income to the beneficiaries, with the tax treatment determined by the original character of the income when it was generated inside the trust. For example, if the CRT distributed income to the donor that was generated when the CRT sold stock, the donor would pay tax on the income at long-term capital gain rates.

> *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.

As explained in Section E above, the CRT is often combined with an irrevocable life insurance trust, commonly known as a "wealth replacement trust." Husband and Wife can use their income tax savings (generated by the charitable contribution deduction) and some of their extra annual cash flow to pay premiums on life insurance owned by the wealth replacement trust. The wealth replacement trust can be structured to benefit their children, thereby "replacing" the assets passing to charity through the CRT. An added benefit of a wealth replacement trust is that it can be structured so that it is excluded from Husband's and Wife's estates, allowing the assets inside the trust to pass tax-free to the children.

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).

CRT as Income Tax Planning Tool. In addition to the charitable planning benefits of using CRTs, a CRT can also serve as a vehicle for a specific tax planning strategy that is not widely used but that could potentially offer tax savings. Generally, distributions from a CRT are treated as income on what is essentially a worst-in-first-out basis.[8] But, if there is no trust income or if the trust income has already been distributed, then any distributed amount will be treated as a return of principal.

Although CRTs are subject to an excise tax on unrelated business taxable income ("UBTI") which includes income from debt-financed property, there is a way for a CRT to borrow money and make the annual distribution to the beneficiary as a tax-free return of principal.

Example: A client has a marketable security with a Fair Market Value of $1 million. Client has $0 basis in the stock, and he would like to diversify and avoid capital gain. On January 2, Client establishes a CRUT with a four year term and 43.75% payout and donates the stock to the trust. At the end of Year One, on December 30, the trust gets a margin loan and pays out to the beneficiary (client) 43.75%. Because the trust had no income in Year One, the distribution is treated as return of principal, and the beneficiary (Client) owes no tax on the distribution.

Then on January 1 of the following year (Year Two), the trust sells the stock for $1 million (assuming no appreciation) and pays back the loan. The trust continues the 43.75% payout over the next three years in the following amounts: Year Two—$246,093.75; Year Three—$138,427.73; Year Four—$77,865.60). The beneficiary (Client) has therefore received a total amount of $899,987.08. Assuming a 23.8% long-term capital gain ("LTCG") tax on the distributions from Years Two, Three and Four,

[8] IRC § 664.

Client will result in paying a total of around $110,048.13 in capital gains tax, which means that the total net to Client will be $789,939.47.

Had Client simply sold the stock without the CRT planning tool, he would have netted $762,000, after taking into account the 23.8% LTCG tax. Therefore, using the trust saves Client $27,939.47. Moreover, upon expiration of the trust, the $100,112.92 remaining in the trust will be distributed to a charity. Thus, Client has been put in a slightly better position, and the charity has received all of what would have gone to the IRS. Essentially, the strategy results in about $128,052.39 of taxes saved.

G. SALE TO GRANTOR TRUST AND MCCORD CLAUSES

The "McCord clause" (so named for the 5th Circuit *McCord* case, as more fully explained below) allows a client to give and/or sell a specific amount of property to a grantor trust benefitting the client's descendants utilizing a valuation adjustment formula clause while also transferring an amount to a charity of the client's choosing. The McCord clause can be a very important tool for a practioner because if hard-to-value assets are sold to a grantor trust and the IRS successfully argues that the assets were worth more than the sales price, then the grantor may owe gift tax (if the grantor has fully utilized his lifetime gift tax exemption). A McCord clause is one way to mitigate this risk. Additionally, a McCord clause can also be used to help further a client's charitable goals.

The McCord clause is a valuation adjustment clause that is included in the sale documentation that complies with the holding in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). In *McCord*, the taxpayers, a husband and wife, transferred all of their limited partnership interests in a certain limited partnership to a GST exempt trust, their sons, and two charitable organizations. The taxpayers directed that a portion of the limited partnership interests equal in value to their remaining GST exemption amounts pass to the GST exempt trust. Second, a portion of the limited partnership interests worth approximately $6.9 million, reduced by the amount passing to the GST exempt trust, would pass to their sons. Third, a portion of the limited partnership interests worth $134,000 would pass to a charitable organization. Fourth, the limited partnership interests remaining after funding the first three gifts would pass to a second charitable organization.

Subsequent to the transfer, an independent appraisal of the limited partnership interests was obtained. Based on this appraisal, the GST exempt trust, the taxpayers' sons, and the charitable organizations entered into a confirmation agreement, in which they agreed on the exact percentage of limited partnership interests allocated to each of them. Under the transfer document, the limited partnership retained a "call" right with respect to the limited partnership interests transferred to the charitable organizations. Approximately three months after the confirmation agreement was signed, the limited partnership exercised its call right and redeemed the charitable organizations' interests in exchange for cash.

The taxpayers filed a gift tax return reporting this transaction. When the gift tax return was later audited, the IRS argued that the value of the limited partnership interests that actually passed to the GST exempt trust and the taxpayers' sons (collectively, the "noncharitable

assignees") was greater than that which was reported on the gift tax return. The IRS's argument was successful in the Tax Court, which found in the IRS's favor. The case was appealed to the 5th Circuit.

The 5th Circuit ultimately held that the fair market value of the limited partnership interests must be determined as of the date of the gift and is not affected by subsequent events. Therefore, the confirmation agreement must be ignored and the IRS could not consider the exact percentage of partnership interests transferred to the noncharitable assignees. Rather, the IRS was bound by the formula clause, which directed that a portion of the limited partnership interests equal in value to approximately $6.9 million pass to the noncharitable assignees. As a result, the taxable portion of the gift would not be greater than $6.9 million.

By using the McCord clause, if the value of the property gifted and/or sold is later determined to be higher than the appraised value, that additional value is also attributed to the charity. Thus, if the value of the property is redetermined by the IRS, the additional value transferred would qualify for the charitable gift tax exemption.

McCord clauses involve careful and intricate drafting, as well as specific procedures to make sure that the charity and the grantor trust deal with each other at arm's length. First, the clients form a grantor trust, naming their descendants as beneficiaries and gift a nominal amount of cash to the trust. The clients then sell a dollar denominated portion of the asset to the trust and the remainder is gifted to a charity (or donor-advised fund as later described).

The transfer document directs that an amount of the assets with a value equal to a certain dollar amount (assume $1 million for illustration purposes) will pass to the trust. The remaining amount of the assets will pass to the charity. The trust executes a promissory note promising to pay $1 million to the clients in exchange for its share of the assets. The portion passing to the charity is treated as a charitable gift. A gift tax return should be filed allocating GST exemption to the cash gift and reporting the above sale to the grantor trust.

The trust and the charity subsequently agree on an allocation of the shares, based on an appraisal that was performed by an independent appraisal firm. Over time, the trust repays the promissory note. After the note is paid in full, the trust is left with the appreciation on the assets. By using this technique, clients can make these types transfers free of gift tax and using a minimal amount of their GST exemptions.

To summarize, if properly drafted and implemented, a McCord clause can substantially reduce the risk of gift tax exposure in the event the IRS argues that the property should be revalued. Because a McCord clause defines the amount transferred in a way that a certain dollar amount passes to family members, and the excess spills over to charity, then in case of a value adjustment by the IRS, any excess value will pass to charity and no additional gift taxes will be due. However, the valuation agreement, where the trust and the charity agree on the amount passing to the charity at the inception of the transaction, locks in the amount passing to the charity, so no additional amount actually passes to the charity once the agreement has been entered into. In the end, this structure is intended to help protect against paying gift taxes if the value of the assets transferred is challenged.

Selling a Business Using a Sale to Grantor Trust. When selling a business, both parties to the transaction generally want to ensure that after the sale, they will achieve the best position possible. Although these goals often seem to conflict, in some instances there may be a way to utilize a grantor trust as vehicle for the sale in a manner which satisfies both parties and leaves both parties with more money in their pockets.

Suppose Seller would like to sell an asset and Buyer is willing to purchase the asset. Rather than conducting an outright sale, Seller first establishes a grantor trust and names Buyer as the beneficiary of the trust. Next, Seller sells the asset to the trust for cash. In order to pay for the asset, the trust can borrow money from Buyer or from a bank. (Borrowing from a bank would likely require the buyer to serve as a guaranty of the loan.) Because the trust is a grantor trust, there would be no gain on the sale. Thus, if the asset is worth $1 million and Seller had a $500,000 basis, Seller would have $100,000 in tax savings (assuming the proceeds are all long-term capital gain and there is no recapture).

Finally, Seller can "turn off" the grantor trust, thereby creating a 678 trust for the benefit of Buyer. The trust now holds the $1 million asset, and Buyer has a $500,000 basis. Although Buyer has a lower basis, he will conceivably have been able to negotiate a lower sale price due to the fact that Seller will avoid paying income tax on the sale. Additionally, there are estate planning benefits for Buyer. For instance, because the trust is a 678 trust, Buyer owns the trust for income tax purposes. Therefore, paying taxes on the earnings from the asset will help Buyer deplete his taxable estate. Moreover, the trust provides asset protection for Buyer. The assets in the trust would not receive an adjustment in basis at the death of the buyer, but assuming the laws do not change, Buyer could repeat the process with a new buyer.

This technique will not always be helpful, especially when the asset sold is a business (the Buyer will be unable to amortize goodwill). However, when the asset sold is a mineral or working interest, this method can reap significant tax savings. By not having any recognized gain on the sale of the asset to the trust, the seller will avoid recapture of intangible drilling costs ("IDC") and any percentage depletion taken on the asset. This can result in substantial savings for the seller, and therefore would conceivably assist the buyer in negotiating a lower sale price.

H. MAXIMIZING THE BENEFIT

A donor can generally deduct contributions of money or property made to or for the use of a "qualified organization" (defined as those organizations described in Code Section 170(c)). However, as explored in depth below, the foregoing statement is very much an oversimplification of the rules related to charitable giving. Not only are there multiple techniques available to structure charitable gifts, there are also many restrictions on, and rules governing, the deductibility of charitable gifts. Moreover, when working with charitably inclined clients, it is important to use techniques in a way that provides the client with the greatest tax benefit. Sometimes, this requires some creativity.

For example, suppose a client has a business with a fair market value of $30 million and a $0 basis. The client is looking to sell the business and would like to donate 10% of the proceeds

to charity. Obviously, the client could simply sell for $30 million, give $3 million to charity, and take the $3 million charitable deduction (cutback limitations would apply). Assuming the client materially participates in the business, there will be no net investment income tax, and the long-term capital gain rate will be 20%. The client will have a net capital gain of $27 million and thus will pay $5,400,000 in taxes.

But, suppose the same client gifted a $3 million interest in his company to the charity and then entered into a contract to sell the business for $30 million. The client will have $27 million in proceeds from the sale and will be able to take a $3 million deduction. The net capital gain will be $24 million, and the client will only pay $4,800,000 in taxes, which amounts to $600,000 in taxes saved.

As another example, suppose the client above does not want to sell his business but does want to give $1 million to a public charity. Assuming the client is in the top tax bracket, giving $1 million cash outright will result in roughly $400,000 of taxes saved through the charitable deduction.

If instead, however, the client gifted to the charity a $1 million interest in the company, the client could take the $1 million charitable deduction and then buy back the interest from the charity for $1 million. The client's basis in the company has risen from $0 to $1 million.

If the company is not a partnership, the client would eventually save around $238,000 in taxes upon the sale of the business. But, if the company is a partnership, it could make a Section 754 election and push the new basis onto the partnership assets, including goodwill. Because goodwill is amortizable (at ordinary tax rates), the client will receive a double deduction for the gift. Essentially, the client will have received a $792,000 tax benefit from a $1 million charitable gift.

I. CHARITABLE GIFT ANNUITY

A charitable gift annuity is created when an individual transfers cash or other property to a charity in exchange for the charity's promise to pay an annuity to the individual for the individual's life. If property is donated, the charity receives the entire property up front and can do whatever it wishes with the property. The donor's charitable contribution deduction is equal to the difference between the amount of cash or other property transferred to the charity and the actuarial value of the annuity.

For income tax purposes, the donor treats the transaction as a bargain sale to the charity. Therefore, as the donor receives annuity payments, a portion of the payments is taxed as capital gain and a portion will be treated as ordinary income. The remaining portion of the annuity payments is taxed as ordinary income.

J. CHARITABLE LEAD TRUSTS

An individual who is predisposed to give a certain amount of assets to a charity each year may be an ideal candidate for the charitable lead trust technique. A charitable lead trust (a

"CLT") is a trust that makes an annual payout (either a fixed amount (a "CLAT") or a variable amount (a "CLUT")) to a charity for a fixed term of years (such as 10, 15, or 20), and at the end of the term, the trust assets pass to the donor's family (typically to the donor's children). CLTs are one of the most underutilized estate and charitable planning vehicles. Because both asset values and interest rates are at historically low rates, now may be the perfect opportunity to utilize the CLT.

Tax Advantages of a CLT. The CLT removes assets from the donor's estate so that the donor avoids estate tax on the assets, but when the term ends, the assets pass to the donor's children. With careful planning, a CLT can be structured so there is no estate or gift tax on the portion of the assets passing to the children at the donor's death.

When CLTs are Beneficial. As noted above, the best time to create a CLT is when interest rates and asset prices are low. Currently, interest rates are at historic lows, which serves to reduce the present value of the remainder interest that passes to the children and makes it easier to avoid paying gift tax on this amount. In addition, when asset prices are low, the assets have more potential to appreciate, which also increases the amount that later passes to the children.

Income Tax Consequences of a CLT. The income tax consequences of a CLT depend on whether the CLT is structured as a grantor trust or a non-grantor trust. If the CLT is a grantor trust, the donor receives an income tax charitable contribution deduction when the CLT is created, but pays income tax each year on the trust's entire taxable income (with no deduction for the amount passing to charity each year). If the CLT is a non-grantor trust, the donor receives no upfront income tax deduction, but the CLT gets a deduction each year for the amount passing to charity.

> *Example*: Husband and Wife own a working interest and mineral interest that, together, are valued at $18,080,000. Husband and Wife are involved in charitable activities and give approximately $100,000 per year to their favorite charities. Additionally, they would like their children to ultimately receive a portion of the working interest.
>
> If Husband and Wife have a net income before taxes ("NIBT") of $3,829,249, they will be over the 3% cutback threshold of $300,000. But because the cutback is capped at 80% of the deduction, if Husband and Wife gift $100,000 to the charity, they will be able to deduct $20,000 (20%). As a result, Husband and Wife will pay $31,680 in taxes on the $80,000 (80%) they were unable to deduct due to the cutback (assuming 39.6% tax bracket). Thus, if Husband and Wife give the charity $100,000 outright every year for ten years, the cutback would cost them an additional $316,800 in taxes.
>
> Suppose instead, however, Husband and Wife decide to create a CLT which the charity receives an annuity for ten years, naming their children as remainder beneficiaries. They gift a portion of the working interest worth $1,808,000 (10%) to the CLT. Assuming the working interest continues to produce income and the CLT plays out 5.531% of its initial assets per year to the charity, the charity would receive an annuity payment of $100,000 per year. At the end of the ten-year term, the charity will have received $1 million.

Because Husband and Wife gifted a working interest, income produced from the interest will be considered UBTI and will be subject to the 3% cutback and 50% limitation on charitable deductions. The 3% cutback threshold for trusts is $11,950. Therefore, by way of comparison, assuming the trust has a NIBT of $382,925 (which represents 10% of Husband's and Wife's total NIBT prior to the 10% gift to the CLT), the 3% cutback amount will be $11,129.25. Comparing this cutback amount to the $80,000 cutback amount applicable to Husband and Wife as individuals, use of the CLT has reduced the cutback by $68,871, which results in a $27,273 tax benefit. Over ten years, the tax savings would be $272,728.18.

Moreover, suppose in Year One the CLT has an adjusted gross income of $384,924. The 50% limitation amounts to $192,462. The 3% cutback amount would be $11,189.22, which means that with a charitable annuity of $100,000, the CLT could actually take a charitable deduction of $88,811. If the CLT earns $1,840,321 over the next nine years (see CLT Income Chart, below, for individual annual calculations), over ten years, the charitable deductions taken by the CLT will amount to $830,549.

CLT Income Chart:

Year	CLT AGI	50% Limitation	Cutback Amount	Charitable Annuity	Charitable Deduction
1	$384,924	$192,462	$11,189.22	$100,000	$88,811
2	$321,451	$160,726	$9,285.03	$100,000	$90,715
3	$276,090	$138,045	$7,924.20	$100,000	$92,076
4	$241,026	$120,513	$6,872.28	$100,000	$93,128
5	$214,312	$107,156	$6,070.86	$100,000	$93,929
6	$191,916	$95,958	$5,398.98	$100,000	$90,559
7	$172,800	$86,400	$4,825.50	$100,000	$81,575
8	$155,566	$77,783	$4,308.48	$100,000	$73,475
9	$140,368	$70,184	$3,852.54	$100,000	$66,331
10	$126,792	$63,396	$3,445.26	100,000	$59,951
					$830,549

If Husband and Wife had kept the working interest in their own name and gifted $100,000 outright every year for ten years, the total amount of charitable deductions they would be able to take would be $200,000. Therefore, using the CLT has allowed a $630,549 increase in allowed deductions, which results in a tax benefit of $249,697.

Additionally, if Husband and Wife gifted 10% of their mineral interest rather than of their working interest, the tax savings would be even greater. Because income from mineral interests is not treated as UBTI, the CLT would have no 3% cutback or 50% limitation and could deduct 100% of the $100,000 charitable annuity each year. Over ten years, this would be a $1,000,000 deduction, which is $80,000 more than the deduction available to

Husband and Wife as individuals making the same gifts. In sum, this would save $347,200 in taxes (assuming the trustee materially participates in the mineral interest so as to avoid the additional 3.8% net investment income tax).

The following table illustrates the results of using a CLT:

	Without a CLT	With a CLT (Working Interest)	With a CLT (Mineral Interest)
Charitable Deduction Over Ten Years:	$200,000	$830,549	$1,000,000
Income Tax Savings:	$79,200	$328,897.40	$396,000
Amount Passing to Charity:	$1,000,000	$1,000,000	$1,000,000

Note: This illustration does not take into account the additional estate tax benefits of charitable giving.

K. PRIVATE FOUNDATIONS

A private foundation is a tax-exempt entity that operates to further its particular charitable purposes. Because a private foundation is exempt from tax, it can sell property without tax consequences. In addition, individuals can donate cash or other property to the foundation and receive a charitable contribution deduction (subject to the limitations noted above).

The first step is to create the entity, which is typically a Texas non-profit corporation with a board of directors of at least three individuals. The next step is to file a Form 1023 Application for Exemption with the IRS seeking a determination letter declaring the entity to be tax-exempt. The tax-exempt status has two benefits:

1. It allows contributors to take an income tax deduction for contributions made to the foundation.

2. It permits the foundation to avoid paying income tax on its income.

In order to obtain and maintain tax-exempt status, the foundation is required to use its funds only for a "charitable purpose," which means it must conduct its own charitable programs or fund other charitable organizations.

Private foundations are subject to certain restrictions. "Disqualified persons" are generally prohibited from entering into "self-dealing" transactions with the foundation, even if the transaction is objectively in the best interest of the foundation. Disqualified persons include members of the board of directors, foundation managers, large donors, and entities related to such persons. In addition, private foundations are prohibited from having "excess business

holdings," which means that disqualified persons and the foundation cannot, in the aggregate, own more than 20% of a business enterprise.

A foundation is also prohibited from holding investments that jeopardize its charitable purpose and is required to distribute at least 5% of the value of its assets to other tax-exempt entities each year. Furthermore, a foundation that incurs "taxable expenditures," such as lobbying expenditures, is subject to tax penalties.

The donor and/or the donor's family members can manage the foundation by being members of the foundation's board of directors. The board of directors determines what type of charitable programs will be conducted by the foundation and which charitable organizations will receive funding from the foundation. These opportunities allow the donor and the donor's family members to participate in charitable giving.

The donor can contribute assets to the foundation during his life as well as upon his death. The foundation will continue to exist long after the donor's death, providing a vehicle through which the donor's children, grandchildren, and great-grandchildren can participate in charitable giving.

L. SUPPORTING ORGANIZATIONS

A supporting organization is a tax-exempt entity that is operated exclusively for the purpose of furthering the tax-exempt purposes of another specific charitable organization. The supporting organization raises and manages its own funds, but all grants it makes are for the purpose of furthering a specific charitable organization's exempt purposes.

Congress and the IRS have placed increasingly prohibitive restrictions on supporting organizations. Much of the restrictions are a result of the Government's concern that terrorist activity is being supported under the guise of charitable organizations. The new rules are an effort to create more transparency in these types of organizations to prevent terrorist activity being supported by tax-deductible dollars.

To qualify as a supporting organization, the entity must be responsive to the needs and demands of the charitable organization that it supports. The supporting organization must also maintain a significant involvement in the supported organization's operations.

These requirements can be satisfied in one of the following ways:

1. The supporting organization must be operated, supervised, or controlled by the supported organization (a "Type I Organization").

2. The supporting organization must be supervised or controlled in connection with the supported organization (a "Type II Organization").

3. The supporting organization must be operated in connection with the supported organization (a "Type III Organization") as follows:

a. At least one of the directors of the supporting organization's board must be elected by the supported organization. In addition, at least one member of the supporting organization's board must also be a member of the supported organization's board; and

b. The supporting organization must maintain a significant involvement in the operations of the supported organization so that the supported organization depends upon the supporting organization for contributions.

A supporting organization is treated for income tax purposes like a public charity. Contributions to the supporting organization benefit from the more generous rules for charitable contribution income tax deductions that apply to public charities. Prior to the enactment of the Act, supporting organizations were not subject to the restrictions discussed above for private foundations. Therefore, they could enter into transactions with "disqualified persons," could have excess business holdings, and were not required to distribute a minimum amount of assets each year.

The provisions of the Pension Protection Act placed greater restrictions on most "Type III" supporting organizations so that they are treated more like private foundations. Type III organizations are the most common supporting organizations, so the Pension Protection Act may have a chilling effect on the creation of these types of entities. In addition, private foundation distributions to Type III organizations no longer qualify toward the private foundation's minimum distribution requirements.

M. DONOR-ADVISED PHILANTHROPIC FUNDS

Through an Individual Charity. This is a fund that consists of one or more accounts established by a donor, which are created for the purpose of distributing funds to qualified charitable organizations. The account becomes the property of the charitable organization when it is established. However, the donor retains the right to recommend how the interest generated by the account should be used to further the organization's charitable purposes.

The donor receives a charitable contribution income tax deduction for the year in which the account is established, governed by the rules for making contributions to a public charity. Because the account belongs to the charitable organization upon its creation, no income tax is generated by the account's earnings each year. Furthermore, the donor does not receive a charitable contribution deduction in the future when distributions from the fund are made. However, if the donor contributes additional cash to the fund in future years, those contributions will qualify for the charitable contribution income tax deduction.

Through a Community Foundation. Often used because it is less complicated than a private foundation, this is a fund created for the purpose of distributing funds to qualified charitable organizations when the donor does not know exactly which charities will be benefitted each year at the time of initial contribution. The donor retains the right to recommend how the

funds should be distributed. The donor receives a charitable deduction for the year in which the account is established, governed by the rules for making contributions to a public charity. Because the account belongs to the community foundation upon its creation, there is no income tax on the account's earnings each year.

A donor-advised fund has the following advantages:

1. Fewer administrative requirements (e.g., simplifies the requirements of having a receipt for each charitable contribution deduction taken on a Form 1040);

2. No separate income tax return is required;

3. The donor has the choice to remain anonymous when the gift is made to the charitable organization from the donor-advised fund;

4. A wider range of investment choices may be available;

5. Higher charitable contribution deduction limitations since the donor-advised fund qualifies as a public charity for most purposes;

6. The organization that administers the donor-advised fund handles the follow-up related to distributions made out of the fund;

7. No minimum distributions are required;

8. Self-dealing rules do not apply; and

9. Easier to "bunch" itemized deductions into every other year (and take the standard deduction in between). A large contribution (i.e., for two years' worth of gifts) can be made every other year to the donor-advised fund, and the donations to specific charities can be made from the donor-advised fund over time. As a result, there is no need to "bunch" donations to the individual charities.

For these reasons, a donor-advised fund should be considered as an alternative or addition to other charitable giving options for clients who are charitably minded.

N. USING NON-CHARITABLE TRUSTS FOR CHARITY

Another option for charitably-inclined clients is one which may not often be considered: establishing a non-charitable trust for charitable purposes. The immediate disadvantage is obvious—no tax deduction for contributions to the trust itself. But, for clients who foresee giving large amounts to charity out of annual income, this technique offers some potentially attractive benefits.

First, allowing a trust to make charitable donations avoids the 50% charitable deduction limitation, the 3% itemized deduction phase-out, and 3.8% net investment income tax, all of which apply to individuals. Second, using a non-exempt trust rather than an exempt, charitable trust allows for more flexibility when dealing with trust assets. By not filing for exemption as a Section 501(c)(3) organization and by omitting from the governing instruments the requirements to be classified as a private foundation under Section 508(e), the trust would have claimed no exemption for its charitable purpose. Further, by not taking a charitable deduction for any contributions made to the trust, the trust would avoid the imposition of private foundation rules under Section 4947(a). Therefore, without any implication of the IRC Chapter 42 private foundation rules, the client would have the ability to exchange assets of equivalent value with the trust and enter into deals and investments without triggering any self-dealing penalties. Moreover, the client would not have to be concerned with any taxes on excess business holdings or on undistributed trust income.

> *Example*: Joe is in the oil and gas business and is very charitably inclined. He would like to establish a private foundation which he could co-invest with him in various deals and projects. In part, Joe wants to avoid the 3% cutback and the 3.8% net investment income tax. At first, this idea does not seem possible due to the prohibited transaction rules applicable to private foundations.
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> Joe's ultimate goals, however, could be achieved by using a private foundation and a non-charitable trust together. If Joe establishes a non-charitable trust, he can contribute assets to the trust (which would count against his lifetime exemption) or he can loan money to the trust (which would not count against the exemption). The trust can then invest in partnerships that Joe owns and manages.
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> Any income earned by the partnerships (such as from mineral or royalty interests which would not be considered UBTI for the trust) is distributed to the trust to the extent of its earned income—after taking into account such things as applicable depletion allowances. Next, the trust contributes all income distributed from the partnerships to the private foundation, thereby receiving a 100% charitable deduction free of the 30% limitation or 3% cutback that Joe would have been subject to had he personally contributed the assets to the private foundation.
>
> Of course, if the partnership earns UBTI, there would be deductibility limits as to the amounts contributed that are attributable to the UBTI. If Joe later decides to repurchase assets from the trust or sell other assets to the trust, he would be able to do so without having engaged in a prohibited transaction.

II. UNDERSTANDING THE NET INVESTMENT INCOME TAX

A. REVIEW OF SELF EMPLOYMENT TAX

Before discussing the new tax under Section 1411, it may be helpful to keep in mind some basic self-employment tax principles. The self-employment tax is comprised of a 12.4% old age, survivors and disability insurance (more commonly referred to as Social Security) tax , which is capped at $117,000 for 2014, and a 2.9% hospital insurance ("HI") tax, which is uncapped.[9]

Beginning in 2013, an additional 0.9% HI tax is imposed on the self-employment income in excess of $200,000 for single taxpayers and $250,000 for joint returns. This additional tax is uncapped and brings the total possible HI tax to 3.8%.[10]

For partnerships, the IRS generally takes the position that a partner cannot also be an employee of a partnership. Thus, although a partner's wages are not subject to payroll tax, the partner's distributive share and guaranteed payment income may be subject to the self-employment tax.[11] But for general partner's, even if the partner's activities are passive in nature, his distributive share is subject to self-employment tax.[12]

The distributable share of income or loss of a limited partner, however, is not subject to self-employment tax.[13] Proposed Treasury Regulations state that an individual is considered a limited partner unless the individual: (1) has personal liability for the debts of, or claims against, the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.[14]

An individual can be both an employee and a shareholder of an S corporation, and a taxpayer's share of an S corporation's trade or business income is not subject to the self-employment tax.[15] Taxpayers may not, however, use S corporation losses to offset other sources of self-employment income.[16] Additionally, any wage payments an S corporation makes are subject to the payroll tax.[17]

B. SUMMARY— NET INVESTMENT INCOME TAX

The new Section 1411 imposes a 3.8% tax on the net investment income ("NII") of individuals, estates and trusts. NII is a broad category of investment income and other unearned

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[9] IRC § 1401(b)(1).
[10] IRC § 1401(b)(2).
[11] Rev. Rul. 69-184, 1969-1 C.B. 256.
[12] IRC § 1402(a)-2(g).
[13] IRC § 1402(a)(13).
[14] Prop. Treas. Reg. § 1.1402(a)-2(h)(2).
[15] IRC § 1402(a)(2).
[16] Treas. Reg. § 31.3121(d)-1(b).
[17] *Id.*

income. In fact, most of what we used to think of as portfolio income is now taxable as NII. Types of NII include:

- Interest
- Dividends
- Annuity Distributions
- Rents
- Royalties
- Income derived from passive activities
- Net capital gain derived from the disposition of property

NII does not include gain on the sale of an interest in a partnership or S corporation if it is not a passive activity. NII also does not include gains on the sale of partnership or S corporation assets if not related to passive activity.

Because NII includes income derived from passive activities, a comprehensive understanding of the Section 469 Passive Loss Rules is vital for purposes of applying Section 1411. To prove a trade or business activity is non-passive, taxpayers must fulfill one of the seven material participation tests found in Section 469. The activities of limited partners, however, are presumptively passive, and limited partners have only three tests available to them by which they may establish non-passive status.

Probable Treatment of an LLC Member. Whether a limited liability company ("LLC") member should be treated as a general or limited partner for purposes of Section 469 has not been clear in the past. However, recent cases suggest that an LLC member can be treated as a general partner, thereby avoiding the passive presumption.[18] Rather than looking solely to the issue of limited liability, the courts in these cases concluded that the member's activities and ability to participate in management were the dispositive issues.[19] Furthermore, this logic matches up with the proposed regulations, discussed above, which define "limited partner" for purposes of Section 1402.

It is important to note that these recent cases, together with the proposed regulations, suggest that it may be more difficult in the future for members of LLCs to characterize themselves as limited partners for self-employment tax purposes.

S Corporations and Limited Partnership Interests. In the end, it appears that only S corporation and limited partnership interests offer the possibility of avoiding both the self-employment tax and the NII tax. This, however, could change. If the proposed regulations defining a limited partner under Section 1402 are ever finalized, many limited partners may become subject to the self-employment tax. Therefore, it seems that using an S corporation may be the only definitive way to avoid paying tax under Sections 1402 and 1411.

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[18] *See Gregg v. US*, 186 F. Supp. 2d 1123 (D. Or. 2000); *Garnett v. Comm'r*, 132 TC No. 19 (2009); *Thompson v. US*, 87 Fed. Cl. 728, acq. in result only, AOD 2010-02, 2010-14 I.R.B.; *Newell v. Comm'r*, TC Memo 2010-23.

[19] *Id.*

C. SECTION 469—MATERIAL PARTICIPATION

A trade or business is a passive activity (subject to 3.8% NII tax) to the taxpayer if the taxpayer does not materially participate.[20] Whether a taxpayer materially participates in an activity is determined on a year-by-year basis. Notably, working interests in oil and gas activities are excepted from the passive loss rules only if liability is not limited.

An individual must satisfy one of seven tests in order to have materially participated in an activity:[21]

1. The individual participates more than 500 hours during the year.

2. Participation by individual constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners) for such year.

3. Individual participates for more than 100 hours during the taxable year and such participation is not less than the participation of any other individual (including individuals who are not owners).

4. The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.

5. The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years preceding the taxable year.

6. The activity is a personal service activity and the individual material participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.

7. Based on all the facts and circumstances, the individual participates in the activity on a regular, continues and substantial basis during such year.

For limited partners, there is a separate material participation rule. Limited partners, will not be found to have materially participated in an activity unless he meets one of the tests in paragraphs 1, 5, or 6, above (> 500 hours). However, if a taxpayer holds both a general and a limited partnership interest all year, he may use any one of the seven tests to qualify.[22]

When calculating hours spent working in an activity, the taxpayer must only include hours involving work in the activity's day-to-day management or operations. Hours spent reviewing financial statements, preparing analysis for personal use, and monitoring the activity

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[20] IRC § 469(c).
[21] Treas. Reg. § 1.468-5T (a).
[22] Treas. Reg. § 1.469-5T(e).

in a non-managerial capacity do not count for purposes of material participation. Additionally, a taxpayer may include a spouse's hours worked in the activity.

There are some factors that indicate a Taxpayer did *not* materially participate in an activity:[23]

1. Taxpayer was not compensated for services.

2. Taxpayer's residence is hundreds of miles from activity.

3. Taxpayer has a W-2 wage job requiring 40+ hours.

4. Taxpayer has numerous other investments, rentals, business activities or hobbies.

5. Activity has paid on-site management and/or employees who provide day-to-day oversight.

6. Majority of hours claimed is for work that does not materially impact operations of the activity.

7. Business operations would continue uninterrupted if taxpayer did not perform claimed services.

Grouping Restrictions. For purposes of determining material participation, taxpayers may group separate activities together.[24] The Treasury Regulations provide that if a group of activities constitutes an appropriate economic unit, then the taxpayer may treat the group as a single activity.[25] Whether a group of activities will constitute an appropriate economic unit depends on the facts and circumstances surrounding the different activities. The IRS has provided a list of factors that should be given the most weight in determining whether activities can be grouped:[26]

1. Similarities and differences in types of trades or businesses;

2. The extent of common control;

3. The extent of common ownership;

4. Geographical location; and

5. Interdependencies between or among the activities.

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[23] Passive Activity Loss ATG – Chapter 4, Material Participation, published in December, 2004 by the IRS; www.irs.gove/Businesses/Small-Businesses-&-Self-Employeed/Passive-Acitivity-Loss.
[24] Treas. Reg. § 1.469-4.
[25] *Id.*
[26] *Id.*

Taxpayers may use any reasonable method when applying the above factors to group their activities, but there are certain activities that are prohibited from being grouped together. For example, a rental activity may not be grouped with a trade or business activity unless one of the two is insubstantial in relation to the other or unless each owner of the trade or business has the same proportionate interest in the rental activity and at least a portion of the rental activity is for use in the trade or business.[27] Note that only the portion of rental activity used in the trade or business can be grouped, and any grouped activities must still constitute an appropriate economic unit. Moreover, an activity that involves the rental of real property may not be grouped with an activity that involves the rental of personal property unless one of the rental properties is provided in connection with the other.[28]

Generally, a taxpayer who owns an interest as a limited partner or limited entrepreneur in an activity described in Section 465(c) may not group that activity with any other activity. The taxpayer may, however, group the activity with another activity in the same kind of business so long as the grouping is otherwise appropriate under the Code.[29] The types of activities described in Section 465(c) are as follows:

1. Holding, producing, or distributing motion picture films or video tapes;
2. Farming;
3. Leasing any Section 1245 property;
4. Exploring for, or exploiting, oil and gas resources; and
5. Exploring for, or exploiting, geothermal deposits.

For activities conducted through a Section 469 entity (which includes partnerships, S corporations, and possibly C corporations), the decision of how to group the activities must be made at the entity level. If an entity groups together activities, then the partners or shareholders may not treat the activities as separate. If, however, the entity treats the activities as separate, then the partners or shareholders may group the activities together if otherwise appropriate.[30] Thus, as a planning point, it would be wise for the entity to treat activities as separate so that the partners or shareholders may choose how and whether to group activities for themselves.

After a taxpayer groups activities together, he cannot, in a subsequent taxable year, regroup or separate those activities unless the original grouping was clearly inappropriate or unless a material change in facts and circumstances has occurred since the original grouping that makes such grouping clearly inappropriate. Note that if either of the two conditions applies, the

[27] Treas. Reg. § 1.469-4(c).
[28] Treas. Reg. § 1.469-4(d).
[29] *Id.*
[30] *Id.*

taxpayer is required to regroup the activities and must disclose to the IRS that a change in grouping has occurred.[31]

Material Participation for Trusts. Whether a trust materially participates in an activity depends on the type of trust involved. For example, the IRS takes the position that a non-grantor trust materially participates in an activity if a fiduciary, in his capacity as such, is involved in the operations of the activity *on a regular, continuous and substantial basis*. The Treasury Department has not yet issued regulations addressing the material participation requirement for trusts and estates. Until regulations are issued, Section 469(h)(1) of the Code remains the standard for determining whether a trust or estate materially participates.

In *The Mattie K. Carter Trust v. US,* a Texas district court held that a trust's participation in a ranching business owned and operated by the trust should be measured by the activities of the trust's employees, as well as those of the trustee.[32] The IRS, however, does not agree with this ruling.[33] In *Carter Trust,* the district court went on to rule that even if the activities of the employees were not counted, the activities of the trustee were sufficient in this case for the trustee to materially participate. The trustee of the Carter Trust managed the trust assets, including the ranch, but the ranch had a ranch manager and other employees who essentially performed all activities for the ranch. The trustee did review and approve all financial and operating proposals for the ranch and handled all of the asset acquisitions and budgeting for the ranch. The trustee kept office hours and spent a significant amount of his time managing the ranch. Notably, the IRS did not appeal this decision.

In *Frank Aragona Trust v. Commissioner*, the Tax Court found that the Frank Aragona Trust materially participated in the real estate business that it conducted through a wholly-owned LLC.[34] The trust had six co-trustees, and of the six, three were full time employees of the LLC. The court held that the trustees' actions as employees counted toward determining material participation of the trust. The Court's holding was generally based on two findings: (1) state law required the trustees to administer the trust solely for the benefit of the beneficiaries of the trust; and (2) state case law had established that trustees cannot avoid their duty of loyalty to a trust by conducting activities through an entity that is owned by the trust.

Whether a grantor trust is a material participant, in contrast, depends on the activities of the grantor, not those of the trustee, consistent with the rules that impose tax on such a grantor as though he were the owner of the trust's assets. For example, if there are five separate trusts with the same trustee, can that trustee's participation count for all of the trusts? Based on the IRS ruling in TAM 201317010, the answer appears likely to be yes.

In TAM 201317010, Trust A and Trust B (both complex trusts) owned an interest in the same S corporation. Trust A and Trust B had the same trustee. The IRS ruled that the trustee's participation in the relevant activities of the S corporation counts toward meeting the material participation requirement of Section 469 only to the extent that such activities were performed in

[31] Treas. Reg. § 1.469-4(e).
[32] *The Mattie K. Carter Trust v. US*, 91 AFTR 2d 2003-1946 (256 F. Supp 2d. 536) (DC TX).
[33] *See* IRS PLR 200733023; IRS PLR 201029014; IRS TAM 201317010.
[34] *Frank Aragona Trust v. Comm'r*, 142 TC No. 9 (March 27, 2014).

the trustee's fiduciary capacity as trustee of Trust A and Trust B. The IRS ruled that time spent serving as an officer of the company does not count toward meeting the material participation requirement. Ultimately, the IRS found that the trustee in this case did not materially participate in the relevant activities of the S corporation.

D. REAL ESTATE PROFESSIONAL EXCEPTION

Presumption. Income from rental real estate activities is generally considered passive (the *per se* passive presumption).[35] Rental activities are therefore considered to fall within Section 1411(c)(2)(passive activity of a trade or business) and are thereby included in NII.

Overcoming the Presumption. The Preamble to the Proposed Regulations provides that the Real Estate Professional exception found in Section 469(c)(7) will also apply in determining a passive activity under Section 1411.[36] Additionally, the Preamble states that in order for income from a rental activity to avoid the NII tax, it must also meet the definition of a trade or business in Section 162.

Qualifying as Real Estate Professional. Closely held C corporations qualify as a real estate professional ("REP") if more than 50% of the corporation's gross receipts for the year are derived from real property trades or businesses in which the corporation materially participates.[37]

Individuals qualify as a REP in any taxable year when:

1. More than half of the personal services the taxpayer performs in a trade or business are performed in real property trades or business in which the taxpayer materially participates, and

2. The taxpayer performs more than 750 hours of services in real property trades or business in which he materially participates.[38]

Real property trades or businesses includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[39] Personal services is defined as any work performed by an individual in connection with a trade or business, with two carve-outs:

1. Personal services does not include any work performed by an individual in the individual's capacity as an investor.[40]

[35] IRC § 469(c)(2).
[36] Prop. Treas. Reg. Preamble § 6.B.i.(b)(2).
[37] IRC § 469(c)(7)(D).
[38] IRC § 469(c)(7)(B).
[39] IRC § 469(c)(7)(C).
[40] Treas. Reg. § 1.469-9(c)(4).

2. Personal services performed as an employee do not count as performed in real property trades or businesses unless the taxpayer is a 5% owner of the employer.[41]

Note: For taxpayers filing a joint return, either spouse may independently fulfill the two REP requirements to qualify both spouses for the exception.[42]

Proving Material Participation. Qualifying as a REP prevents the taxpayer's rental activities from being treated as *per se* passive, and the taxpayer may then attempt to prove material participation in each rental activity using the seven tests for material participation.[43]

Before applying the material participation tests, the taxpayer may make an "all-or-nothing" election, which allows the taxpayer to elect to treat all interests in rental real estate as one activity.[44] If the taxpayer does not choose to treat all interests as one activity, then each separate interest in rental real estate must be treated as a separate activity.[45]

Additionally, if the taxpayer owns any rental activities in the form of a limited partnership interest, choosing to aggregate may cause all rental real estate activities to be treated as a limited partnership interest, which means the taxpayer may only use the three material participation tests available to limited partnership interests to prove the taxpayer materially participated in the activity.[46]

Remember, even if the taxpayer proves material participation in rental real estate activities, the rental activities must still meet the requirements of a trade or business under Section 162.

*Additional Note***:** In 2012, the Office of Chief Counsel stated that the IRS position is that a trust is not an "individual" for purposes of Section 469(c)(7) and thus may not qualify as a REP.[47] However, in *Frank Aragona Trust* (discussed above), the Tax Court rejected the IRS's position and held that if the trustee is an individual, then work performed by the trustee would be considered work "performed by an individual" under Section 469(c)(7). Thus, the trust would be capable of performing personal services and could qualify for the REP exception.[48]

E. PLANNING FOR THE NET INVESTMENT INCOME TAX

Although reducing a client's adjusted gross income below the applicable NII tax threshold is a way to avoid the tax, it is a strategy that might not always be possible. Therefore, it is important to be aware of other ways to reduce the impact of the NII tax on clients. This is

[41] Treas. Reg. § 1.469-9(c)(5).
[42] Treas. Reg. § 1.469-9(c)(4).
[43] Treas. Reg. § 1.468-5T(a).
[44] IRC § 469(c)(7).
[45] *Id.*
[46] Treas. Reg. §§ 1.469-9(f)(1), 1.469–5T(e)(2).
[47] IRS CCA 201244017.
[48] *Frank Aragona Trust v. Comm'r*, 142 TC No. 9 (March 27, 2014).

especially true in light of the fact that, given the way the tax is structured, it would be possible for a client to have a net loss for the year and yet still owe NII tax.

Entity Structure. Because of the Passive Loss Rules, operating losses cannot help offset net investment income. There are, however, some ways to plan around this rule. For example, suppose a client and his business partner establish Partnership One, which operates a car dealership. They have also, however, established Partnership Two, which owns the land on which the car dealership is located. With this business structure, the income earned by Partnership Two would likely be net investment income, and any net operating losses from Partnership One would not be available to offset the net investment income.

But, if the partners instead establish a holding company, which then owns both Partnership One and Partnership Two, the holding company would then be able to use the net operating losses of Partnership One to offset the net investment income of Partnership Two.

A similar tactic could be useful in the context of a husband and wife who own two limited liability companies: one which owns the car dealership (Operating LLC) and one which owns the land that is leased to the car dealership (Land LLC). If the husband and wife own the LLC as community property, they can choose whether they would like the LLCs to be treated as disregarded entities or partnerships.

If husband and wife elect to have the LLCs treated as partnerships, the rent paid to the Land LLC will be subject to the NII tax. If, however, the husband and wife elect to treat the companies as disregarded entities, the income received under the lease will not be treated as rent and thus will not be subject to the NII tax.

Note that if the companies are treated as partnerships and the husband and wife desire to change the entity status to disregarded entities, the partnerships will be treated as having been dissolved and the assets distributed to the husband and wife. This dissolution can trigger taxation in some instances.

Charitable Remainder Trusts & Charitable Lead Trusts. Because the AGI is computed before taking out itemized deductions, using tactics to increase itemized deductions—such as through charitable giving—will not reduce the NII of the taxpayer. However, a different rule applies for trusts and estates. Section 642(c) allows trusts and estates to use charitable deductions to offset NII. Thus, if taxpayers hold assets that would otherwise push them over the NII tax threshold, it may be wise to place those assets in either a charitable remainder trust or a charitable lead trust. The trust could make charitable distributions which would offset any NII, and it could do so free of the 30 or 50% limitations and 3% cutback which apply to the charitable contributions of individuals. Moreover, the taxpayer could reduce his AGI, possibly below the NII tax threshold.

Note: Any NII received by a CRT prior to 2013 will not be considered NII.[49]

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[49] Treas. Reg. § 1.1411-3(c)(2).

Roth IRA Conversion. Because money distributed from an IRA is not characterized as NII, the value of having an IRA has arguably increased. The amount distributed from the IRA, however, pay push taxpayers over the NII tax threshold, which is why, in some instances, it may be wise to convert an IRA to a Roth IRA.

> Example: Mark and Cindy are married and together have an AGI of $230,000, which is below the NII tax threshold. Therefore, they do not have to worry about paying a tax on any net investment income. Mark and Cindy, however, own IRAs and will soon reach the age of 70. Moreover, the minimum required distribution that will commence once they reach 70 will put them over the NII tax threshold. Mark and Cindy would like to avoid paying NII tax, and they do not need the full amount of the required distribution for their living expenses. In this instance, it may be wise for Mark and Cindy to convert their IRAs to Roth IRAs. Although doing so may incur a big tax for the year of conversion, it would be a one-time tax. Because Roth IRAs do not have any minimum required distributions, Mark and Cindy could determine each year how much they withdrawal, thereby ensuring they remain under the NII tax threshold.

III. OTHER TOOLS FOR HIGH-INCOME TAX PLANNING

This outline is obviously not a comprehensive list of all the tools necessary for efficient tax planning. Rather, included below is a grouping of miscellaneous tax planning ideas, many of which are likely familiar, but some of which may reveal new aspects to old tools that should prove helpful for high-income tax planning.

A. PRIVATE PLACEMENT LIFE INSURANCE

What Constitutes Life Insurance. Section 101(a) generally provides that amounts received under a life insurance contract are not includible in gross income, so long as the amounts are paid by reason of the death of the insured. The requirements for what exactly qualifies as a life insurance contract can be found in Section 7702.

First, a life insurance contract must be considered to be a life insurance contract under applicable law (state or foreign), and because applicable state law generally includes extensive insurance regulations, it is likely that only commercial life insurance policies issued by life insurance companies will qualify as life insurance contracts.

Next, the contract must satisfy one of two tests: (1) the cash value accumulation test; or (2) the guideline premium limitation, coupled with the cash value corridor requirements.[50] To satisfy the cash value accumulation test, the terms of the contract must provide that the cash surrender value of the policy can never exceed the net single premium that would have to be paid in order to fund the future benefits under the policy.[51] To satisfy the second test, the contract must first meet the guideline premium limitation requirement. This requirement will be met if the sum of all premiums paid under the contract never exceeds the guideline premium limitation.

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[50] IRC § 7702.
[51] IRC § 7702(b).

The guideline premium limitation is the greater of the guideline single premium or the guideline level premium, each of which are defined as follows:

1. The guideline single premium is the premium amount that would be required to fund the future benefits under the policy, determined as of the date the contract is issued. The amount takes into account reasonable mortality charges, fees and interest at the rate of 6% or the applicable federal rate, whichever is greater.

2. The guideline level premium is the level annual premium amount that would fund the future benefits of the policy, if paid over a period of years lasting at least until the insured's 95th birthday.

If the life insurance contract meets the guideline premium limitation, it must then satisfy the cash value corridor test in order to qualify as a life insurance contract. As long as the death benefit provided under the policy is never less than the applicable percentage of the contract's cash surrender value, the cash value corridor test will be met.

The applicable percentage is provided in Section 7702(d) as follows:

In the case of an insured with attained age as of beginning of contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Notably, if a life insurance contract is a variable policy (as defined in Section 817(h)) based on a segregated asset account the investments in which are not adequately diversified, then the contract will not be treated as a life insurance contract under Section 7702(a), regardless of whether the contract satisfies one of the two tests discussed above.

Additionally, there is yet another test that defines the treatment of a life insurance contract under the Code: the 7-pay test. If a contract was entered into after June 21, 1988, and

satisfies one of the two tests established in Section 7702 but fails the 7-pay test, it will be treated as a modified endowment contract.[52] A contract will fail the 7-pay test if the accumulated amount that has been paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before such time had the contract provided for paid-up future benefits after the payment of seven level annual premiums.[53] Moreover, if a contract is materially changed, it is considered to be a new contract that must satisfy the 7-pay test again.

Section 72(e)(10) governs the income tax treatment of modified endowment contracts. Essentially, any amounts received under the contract will be treated first as taxable income and then as return of basis. Moreover, any amount received from the contract that is includible in gross income will be subject to an addition 10% tax under Section 72(v). There are certain circumstances, however, when the tax will not apply.[54] Further, if the client has no intention of taking any money out during his life, a modified endowment contract would not necessarily be a bad investment. The death benefit remains untaxed at the insured's death.

In addition to the tax-free build-up of assets within the insurance policy and the tax-free death benefits provided upon the death of the insured, there is another beneficial use to life insurance contracts: borrowing against the policy. Owners of a life insurance policy can typically borrow against the cash value of the contract without the loan amount being taxable to the owner. Generally, the loan does not have to be repaid, but the owner will likely have to pay interest on the amount withdrawn. Moreover, it is important to always leave enough cash inside the policy to continue paying the premiums. However, if the policy is a universal life policy, then the owner of the policy should have the ability to decrease the face value of the policy to ensure enough cash is on hand.

Utilizing Private Placement Life Insurance for Tax Planning. The use of private placement life insurance ("PPLI") can be an attractive tax planning option for high net worth clients. Beyond the reduction in income tax liability from assets allowed to grow tax-free, PPLI can offer significant asset protection. The most attractive aspect of PPLI, however, is generally considered to be the investment options it provides. Moreover, the fees associated with establishing and maintaining PPLI are often significantly lower than those of other insurance options.

As a threshold matter, PPLI must satisfy the life insurance requirements of Section 7702 (discussed above), but to achieve tax-free accrual of policy cash values, the PPLI must also meet the diversification requirements and must comply with the investor control doctrine.[55] Section 817 requires assets within the contract's segregated asset account to be adequately diversified, which, according to the Regulations means that (1) the account must hold investment securities from at least five different issuers, and (2) of the account's total assets value:

1. No more than 50% may be represented by any one investment;
2. No more than 70% may be represented by an two investments;

[52] IRC § 7702A.
[53] IRC § 7702A.
[54] IRC § 72(v).
[55] IRC § 817.

3. No more than 80% may be represented by an three investments; and
4. No more than 90% may be represented by any four investments.[56]

Note: Securities from the same issuer and interests in the same real property project or the same commodity will be treated as a single investment.

The determination of whether the segregated asset account is adequately diversified occurs on the last day of each quarter of the calendar year. There are, however, grace periods for certain segregated asset accounts. For instance, if the account is not real property, then the quarterly diversification is delayed by one year. And, if the account is real property, then it is treated as being adequately diversified for five years or for one year after the account ceases to be real property, whichever is earlier.[57]

There are exceptions to the adequately diversified requirement. If a segregated asset account fails the adequately diversified test because of a fluctuation in the market rather than because of the acquisition of a new asset, then the account will be treated as being adequately diversified.[58] Additionally, there is a safe harbor provision which states that an account will be treated as adequately diversified if two requirements are met:

1. At least 50% of the value of the account's total assets are represented by cash or securities (from the Government or regulated investment companies) and no more than 25% are invested in the securities from (a) any one issuer, (b) any two issuers engaged in the same or similar trades or businesses, or (c) one or more qualified publicly traded partnerships; and

2. No more than 55% of the value of the account's total assets are cash or securities.[59]

In some instances, the "look through" rule applies, which provides that an investment in a fund is treated as an investment in all of the funds underlying assets rather than as a single investment. When applicable, this rule makes satisfying the diversification requirements much easier.[60]

One of the main attractions of PPLI is certainly the broad range of investments available, including hedge funds, real estate investment trusts, private equity, and commodity funds, to name a few. A PPLI owner cannot, however, take part in any conduct that could be deemed to be investor control. According to the investor control doctrine, a contract owner who does engage in such conduct will cause the contract to forfeit its tax-preferred treatment.[61] Although clients cannot technically select their own investment advisor, it is likely they could share their

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[56] IRC § 817(h); Treas. Reg. § 1.817-5(b).
[57] Treas. Reg. § 1.817-5(c).
[58] Treas. Reg. § 1.817-5(d).
[59] IRC §§ 817(h)(2), 851(b)(3).
[60] Treas. Reg. § 1.817-5(f).
[61] *See* Rev. Rul. 2003-91.

preference with the insurance company and allow the insurance company to decide whether the preference would be a good selection.

One of the advantages high net worth clients have when establishing a PPLI contract is their ability to use money outside of the policy to pay insurance agent's fees and administrative fees which increases the cash value available for tax-free build up. Additionally, the client may be able to negotiate down the standard agent's fees or offer an up-front flat fee that could also end up saving a significant amount of money long-term.

When large amounts are at stake, it often opens the door to exotic or creative investments. State regulations, however, generally require certain levels of liquidity within the insurance company's assets, which is why high-income clients often look to offshore PPLI companies where liquidity limitations are typically more flexible.

B. CAPTIVE INSURANCE

Law. Generally, income earned by insurance companies (other than life insurance companies) are taxed at corporate rates.[62] Insurance companies with net written premiums of less than $1.2 million in a given year, however, pay taxes only on their investment income. Their premium income is not taxed.

Advantages. Although captive insurance companies must be taxed as a C corporation (thus any investment gains will be taxed at C corporation rates), there are advantages to utilizing a captive insurance company, including:

- Amount contributed to the captive is protected from creditors.
- Provides specific coverage for gaps in commercial coverage.
- Owner can declare dividends, which would be taxed at qualified dividend rate.
- Upon liquidation of the assets, the proceeds to shareholders are taxed at LTCG rates. However, the amount earned inside is subject to two levels of tax (35% corporate rate and 20% capital gains rate).

Basic Rules:

- Assets must be available for claims (mostly liquid assets).
- Any investment over 10% of assets needs (state) regulatory approval.
- Reinsurance is not required. The plan must simply be actuarially feasible. (The Texas Department of Insurance has not issued regulations related to captive insurance.)

[62] IRC § 831(a).

- Captive regulations—IRS states only for *related* businesses.
- If audited, the IRS will likely request a feasibility study and an actuarial report.

Three Basic Requirements:

1. Insurance risk;
2. Operate as an insurance company; and
3. Risk shifting and risk distribution.

IRS Guidance.

1. Revenue Ruling 2002-75 – The IRS will begin to issue private letter rulings related to the existence of legitimate insurance between related parties.

2. Revenue Ruling 2002-89 (Third Party Risk Safe Harbor) – Subsidiary insurer receiving at least 50% of unrelated non-parent premiums constitutes adequate risk distribution. Therefore, premiums parent company pays are deductible as a business expense.

3. Revenue Ruling 2002-90 (12 Entity Safe Harbor) – Premiums paid by 12 subsidiaries of the same parent company are deductible as to the parent company (insurer) because so long as the payment of each subsidiary accounts for no less than 5% and no more than 15% of the total premiums paid and the subsidiaries operate as unrelated parties, this arrangement constitutes adequate risk distribution.

   Other important factors the IRS considered relevant:

   - The 12 subsidiaries have significant, homogenous risk.
   - The parent company provides adequate capital to the insurance company.
   - The insurance company is licensed under state law.
   - The premiums paid to the insurance company at arms-length and are consistent with customary industry rating formulas.
   - The parent company makes no guarantees in favor of the insurance company, and the insurance company makes no loans to the parent company.

4. Revenue Ruling 2002-91 (Group Captive Safe Harbor) – A group captive arrangement that includes less than 31 unrelated insurance companies, each of which accounts for less than 15% of the total risk insured, constitutes adequate risk distribution.

5. Revenue Ruling 2005-40 – No risk distribution if insurer only insures one entity.

   Subsidiaries that are disregarded entities owned by the same parent company are not separate unrelated entities for purposes of the 12+ unrelated entities safe harbor rule.

6. Revenue Ruling 2007-47 – Company engages in business that is inherently dangerous to people and property.

   IRS: insurance risk must be a "fortuitous occurrence of a stated contingency"—there must be a risk of economic loss.

   IRS concluded that the "policy" intended to pay for the inevitable cost of cleanup when the company moved locations was not "fortuitous" because there was never any doubt that the cleanup would eventually be necessary.

   No insurance because the cost of cleanup was not an insurance risk.

Salty Brine.

1. Tax benefits should be the "frosting" rather than the motivation.
2. Court found:
   - The "insurance" was for tax and estate planning purposes.
   - The premiums were not based on any genuine risk.
   - There was no shifting of risk.
   - There was no risk distribution.

C. FRANCHISE TAX—BUSINESS TRUSTS

Suppose Elsie is a dairy farmer. The profit margin for a dairy business is very low, and many of the dairy farming expenses cannot be deducted. Therefore, it is extremely important for a dairy farmer to avoid paying franchise taxes.

If a trust is set up for Elsie and her family (a 678 trust), and Elsie sells the dairy farm to the 678 trust, is the 678 trust subject to Texas franchise tax as a "business trust"? If Elsie sets up a spousal limited access trust for her husband and children and gifts dairy cows to the trust, is the trust subject to Texas franchise tax as a "business trust"?

The Texas Tax Code includes a "business trust" in the definition of a taxable entity, which is subject to franchise tax.[63] However, it goes on to exclude a grantor trust from the definition of a taxable entity unless the trust is taxable as a business entity pursuant to Treasury Regulation 301.7701-4(b).[64]

Pursuant to the Regulations, business trusts are generally created by the beneficiaries as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code.[65] Further, the Supreme Court's decision in *Morrissey v. Commissioner* is credited with creating the two-prong test that requires the presence of both a "business objective" and "associates" for a business trust to exist.[66]

In *Morrissey*, the taxpayers formed a real estate trust named the Western Avenue Golf Club, and the trustees were empowered with all acts necessary to purchase lands as well as to construct a golf course and club house. The trust beneficiaries were issued transferable certificates of beneficial interests and had the right to make recommendations to the trustees. In an ordinary trust, beneficiaries do not "plan a common effort or enter into a combination for the conduct of a business enterprise." By contrast, a business trust is a medium for the conduct of a business and the sharing of gains, and those who become beneficiaries (at the outset or later) seek to share those gains.

The Court ruled that the Western Avenue Golf Club trust possessed both (1) a business purpose, and (2) associates and, therefore, was an association taxable as a corporation rather than as an ordinary trust.

First Prong: When does a "business purpose" exist? In *A.A. Lewis & Co. v. Commissioner*, a case decided by the Supreme Court two years after *Morrissey*, the Court ruled that the trust in question was not an association taxable as a corporation because the trustee's powers were carefully limited to prevent the trustee from engaging in any business activity and to permit only the collection and distribution of proceeds from sales.[67]

Later cases and Revenue Rulings indicate that the existence of a "business purpose" is determined solely from an examination of the trust instrument and the breadth of the trustee powers thereunder, rather than from the actions, former or current, of the trustee. Broad powers conferred by the trust instrument will create a "business purpose."[68]

Second Prong: When are "associates" present? In *Elm Street Realty Trust v. Commissioner*, the Tax Court ruled that the concept of "associates" requires the existence of individuals who both possess a beneficial interest in the entity and associate together in a

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[63] Tex. Tax Code § 171.0002(a).
[64] Tex. Tax Code § 171.0002(c).
[65] IRC § 301.7701-4(b).
[66] *Morrissey v. Comm'r*, 296 US 344 (1935).
[67] *A.A. Lewis & Co. v. Comm'r*, 301 US 385 (1937).
[68] *Id.*, *Sears v. Hassett*, 111 F.2d 961 (1st Cir. 1940), *Wyman Building Trust v. Comm'r*, 45 BTA 155 (1941), Rev. Rul. 78-371, and Rev. Rul. 79-77.

common business enterprise.[69] The "associates" requirement is not satisfied unless there is some concerted, purposeful, and voluntary effort by the beneficiaries to either plan or join a pre-existing business activity for the purpose of sharing the fruits of its business activity.

The Tax Court went on to rule in *Elm Street Realty Trust* that when a trust instrument vests exclusive power and authority over trust matters in the trustee, thereby precluding non-grantor, gratuitous beneficiaries from sharing this power, "associates" will not exist. Thus, the Tax Court held that the *Elm Street Realty Trust* was an ordinary trust because its beneficiaries (who received their interests as gifts and did not create the trusts) had no voice over trust matters.

In *Bedell v. Commissioner*, the Tax Court determined that a trust lacked "associates" and was, therefore, an ordinary trust.[70] In *Bedell*, a testamentary trust was created for the benefit of the decedent's spouse, three children, and six grandchildren. The three children were named as co-trustees and had complete management power, but a son-in-law was employed as the actual manager of trust property, which included a family manufacturing business and the rental of several real estate parcels. The beneficial interests were considered too personal to be freely transferable.

The IRS took the position that the trust was taxable as an association because it has an obvious business objective and because three beneficiaries participated in the control and management of the business. The Tax Court, however, disagreed based on the following:

- The decedent had created the trust;
- The beneficial interests were not freely transferrable, thus indicating a preservation of property purpose rather than a joint business undertaking; and
- The participation in the control by only a few of the beneficiaries (as trustees) did not make the beneficiaries "associates."

A few years after *Bedell*, the IRS issued a field service advice memorandum setting forth four criteria that it would consider in classifying trust beneficiaries as "associates:"[71]

- Whether the beneficiaries planned a common effort or entered into a combination for the conduct of a business enterprise;
- Whether the beneficiaries affirmatively entered into the enterprise through purchase of their beneficial interest;
- Whether the beneficiaries were restricted against assigning their interest in the trust; and
- Whether the beneficiaries could control the trust as beneficiaries.

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[69] *Elm Street Realty Trust v. Comm'r*, 76 TC 803 (1981).
[70] *Bedell Trust v. Comm'r*, 86 TC 1207 (1986).
[71] IRS FSA 1999-876, Vaughn #291.

D. BASIS ADJUSTMENT AT DEATH VS. "STEP-UP" AT DEATH

Generally, Section 1014 provides that the recipient of property acquired from a decedent may use the fair market value of the property as of the date of the decedent's death as the recipient's basis in the received property. The Code specifically defines what constitutes property acquired from a decedent. For example, any property received without full and adequate consideration under a general power of appointment exercised by the decedent by will qualifies as property acquired from the decedent.[72]

Additionally, a surviving spouse's one-half share of community property held by the surviving spouse and decedent will constitute property acquired from the decedent, but only so long as at least one-half of the total value of the property is includible in the gross estate of the decedent regardless of whether the estate of the decedent is required to pay estate tax or file an estate tax return.[73]

Although low-basis assets held at death receive a step-up in basis, if those same assets had been gifted to a grantor trust or 678 trust, they would receive no step-up in basis at death. Utilizing grantor or 678 trusts, however, can be an effective way to preserve the basis of high basis assets by avoiding the possibility of the assets receiving a step-down adjustment at the time of death.

If high basis assets are placed into a partnership, there is always the risk that the value of the partnership will have decreased by the time of death, which could have adverse implications in the event that a Section 754 election is in place. How significant these implications would be, however, depends on whether the successor to the partnership interest plans to immediately sell the interest. To achieve the best results for clients, any strategy, but especially those involving high or low basis assets, requires a thorough understanding of the client's goals with respect to the effected property.

> _Example_: Suppose a husband and wife own several low basis real estate assets and would like the assets to be characterized as community property. Owning these assets as community property would likely result in each spouse's interest receiving a discounted valuation for having an undivided interest in real estate. Further, at the death of the first spouse, the surviving spouse's basis in the assets would also be adjusted to fair market value, which could have negative implications depending on the surviving spouse's goals for the property.
>
> In this situation, it would typically be better to grant each spouse, as separate property, his own real estate assets of equivalent value. This would avoid the discounts associated with undivided interests and prevent a negative adjustment in basis for the surviving spouse.

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[72] IRC § 1014(b).
[73] *Id.*

E. SELF-DIRECTED IRA

Use as Investment Vehicle. A self-directed IRA offers all of the same tax benefits of a general IRA but with the added benefit of allowing the IRA owner to maintain active control of his retirement investments. Moreover, a self-directed IRA offers a broader range of investment opportunities and allows the IRA owner to select the investments with which he feels most familiar and comfortable.

A self-directed IRA may hold various types of investments, including the following: individual, publicly traded stock; tax liens; real estate; mortgages and deeds of trust; limited liability companies; partnerships; promissory notes; shares of a regulated investment company; and private stock offerings. Notably, there are two noted disadvantages to placing these types of investments in an IRA: the lack of capital gains treatment on any profits, and the inability to deduct losses.

When utilizing self-directed IRAs, keep in mind both the possibility of incurring UBTI and the potential for engaging in a prohibited transaction under Section 4795 of the Code.[74] For purposes of an IRA, UBTI is defined as income derived from a *trade or business* that is regularly carried on by the IRA and that is not substantially related to the tax-exempt purpose of the IRA.[75]

The unrelated business income tax also applies to any unrelated debt-financed income.[76] It does not, however, apply to most passive investment income, including the following:

- Dividends (including dividends on a real estate investment trust),
- Royalties,
- Most rents from rental property,
- Annuities, or
- Gains from the sale, exchange, or other disposition of property other than inventory or property held for sale in the ordinary course of a trade or business.[77]

It is also important to be aware of the Department of Labor's ("DOL") plan asset regulations, which establish a "look-through" rule for characterizing the assets of an IRA plan. The plan asset regulations ("DOL Regulations") provide that an IRA invests in an equity interest of an entity that "is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940," then the assets of the IRA

[74] IRC §§ 408(e)(1), 511-514.
[75] *Id.*
[76] *Id.*
[77] IRC §§ 511-514.

"include both the equity interest and an undivided interest in each of the underlying assets of the entity."

The look-through rule, however, does not apply if the entity is an operating company or if the benefit plan investors hold less than 25% of any class of equity interest in the entity.[78] Additionally, the rule is especially significant for self-directed IRAs because the DOL Regulations further provide that "any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan."[79] Because the DOL treats those who manage the underlying assets as fiduciaries, this rule may result in people associated with plan engaging in prohibited transactions. Thus, a thorough understanding of the prohibited transactions rules (discussed below) is vital to the effective use of a self-directed IRA.

<u>Section 4795: Prohibited Transactions</u>. Section 4975(e) includes IRAs within the definition of "plan," which means IRAs are subject to all of the prohibited transaction rules. Transactions between an IRA and certain "disqualified persons" are prohibited. And, even though IRAs are generally not plans under the Employee Retirement Income Security Act ("ERISA"), for purposes of the prohibited transaction rules, the DOL maintains jurisdiction, which includes the task of reviewing the requests of individuals for exemption from the rules.

Prohibited Transactions include the following:

1. The sale or exchange, or leasing, of any property between a plan and a disqualified person.

2. The lending of money or other extension of credit between a plan and a disqualified person.

3. The furnishing of goods, services, or facilities between a plan and a disqualified person.

4. The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan.

5. The act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account.

6. The receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

[78] 29 CFR §§ 2510.3-101(a)(2), 2510.3-101(c), 2510.3-101(f).
[79] 29 CFR § 2510.3-101(a)(2).

The following are Disqualified Persons:

1. Fiduciary.

2. Person providing services to the plan.

3. An employer any of whose employees are covered by the plan.

4. An employee organization any of whose members are covered by the plan.

5. An owner, direct or indirect, of 50% or more of:

    a. The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

    b. The capital interest or the profits interest of a partnership, or

    c. The beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization whose employees or members are covered by the plan.

6. A family member of any individual described in (1), (2), (3), or (5), above.

7. A corporation, partnership, or trust or estate of which (or in which) 50% or more of:

    a. The combined voting power of all classes of stock entitled to vote or the total shares of all classes of stock of such corporation,

    b. The capital interest or profits interest of such partnership, or

    c. The beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in (1), (2), (3), (4), or (5), above. [Note that (6) is not included.]

8. An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or a highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7), above.

9. A 10% or more (in capital or profits) partner or joint venture of a person described in (3), (4), (5), or (7), above.

For this purpose, a family member is defined as a spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.

IRA Owner Performs Services for IRA. An IRA owner can perform services for his IRA, but the owner cannot receive compensation for those services because doing so would constitute a prohibited transaction.[80] Although there is an exemption in Section 4975(d) which states that the prohibitions do not apply when reasonable compensation is paid, the IRS interprets this exemption as inapplicable to the relevant prohibition provisions.[81] Specifically, the IRS points to Section 4795(f)(6)(a) for its position that there is no exemption that would allow IRA owners to receive compensation for services.

An argument can be made that the statutes actually support the contrary position. The beginning of Section 4795(f)(6)(a) states that the provision applies "[i]n the case of a trust described in Section 401(a)." Traditional IRAs do not fall within the scope of Section 401(a).[82] Thus, for traditional IRAs, this provision would not prevent the exemption from applying to reasonable compensation for IRA owners.

This argument, however, is wholly inconsistent with the IRS position. Moreover, because distributions from the IRA would avoid the 3.8% net investment income tax, most IRA owners would likely prefer distributions over receiving a salary.

Effect of a Prohibited Transaction. If the *IRA owner or his beneficiary* engages in a prohibited transaction, the IRA ceases to be an IRA, thereby losing its favorable treatment for income tax purposes. If this occurs, the IRA is treated as being disqualified as of the first day of the taxable year in which the prohibited transaction occurred. Additionally, a distribution to the extent of the fair market value of all assets in the account is deemed to have occurred on the first day of the taxable year and is includible in the gross income of the distributee.

If the individual for whose benefit the IRA is established, during any taxable year, uses the account or any portion of the account as security for a loan, the portion so used is treated as distributed to that individual.

If anyone other than the individual for whose benefit the IRA is established or such individual's beneficiaries engages in a prohibited transaction with respect to the individual's IRA, such person will be subject to an excise tax on the amount involved in the transaction. The excise tax may be either 15% of the amount involved or 100% of the amount involved, depending on the circumstances of the prohibited transaction.

> *Example:* If a client wants to use his IRA to buy rental property, he could go to an institution and create an LLC to be owned by the IRA. The IRA owner serves as manger or president of the LLC but receives no salary.
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> The LLC could then engage in a range of investments including buying rental real estate (but be aware of possible UBTI), making mortgage loans for people buying homes, buying raw land with the hope of appreciation, investing in a business, or purchasing a mineral or working interest.

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[80] IRC § 4975(c).
[81] Treas. Reg. §§ 54.4975-6(a)(1).
[82] Traditional IRAs are not trusts and are not established by an employer for the benefit of employees.

Note that while income from mineral interests is excluded from UBTI, income from working interests is included in UBTI unless the owner of the interest is somehow relieved of development costs through the terms of an agreement with the operator. Paying UBIT can be acceptable so long as the client is willing.

Additionally, the client could enter into a partnership in a manner which would allow the partnership to transact with the IRA-owned LLC without violating any of the prohibited transaction rules. For example, if the client and two unrelated parties form a partnership, and each of the three parties owns less than 50% of the partnership, then the partnership itself, as well as each partner, would not be considered a disqualified person. This partnership could then transact with the LLC as desired.

Further, if the other partners wanted to create a new entity, the IRA could invest in the entity up to a 50% interest (to avoid becoming a disqualified person). The interest in the entity could be discounted, and the IRA could convert to a Roth IRA, taking advantage of the discounted valuation of the entity interest. Upon converting to a Roth IRA, all subsequent distributions of the IRA would be tax-free.

It is important to think of the benefits of IRAs and Roth IRAs correctly. Unless a client's tax rate is likely to be lower in the future, the advantage of using an IRA is not in the postponement of taxation but in the tax-free growth of IRA assets.

F. ENTITY CHOICE: S CORPS VS. PARTNERSHIPS

Different Tax Rules. S corporations and partnerships are not subject to the same tax rules. Some of the differences are:

1. A partner's outside basis may be increased when a partnership borrows money. However, an S corporation shareholder's outside basis is not increased when the corporation borrows money.
2. Distributions from an S corporation are always tax recognition events. Distributions from partnerships are not generally tax recognition events (with some exceptions).
3. Partnerships can be owned by anyone. An S corporation cannot have a non-resident alien, a partnership, a corporation (with one exception), or an ineligible trust as a shareholder.
4. The basis of partnership assets is sometimes adjusted when capital transactions occur. That is not true for S corporations.
5. An S corporation shareholder is not subject to the new 3.8% NII tax if the income from the S corporation is not passive as to the shareholder.

6. A sale of a partnership interest can generate ordinary gain (as opposed to capital gain) if the partnership has built in ordinary gain items. That is not true for S corporations.

Instead of using a business corporation structure, use an LLC which elects to be an S corporation for federal income tax purposes.

Structuring Ownership of Business Entity for Optimal Estate Planning. Consider owning entity interests in a trust rather than individually. Interests owned in irrevocable trusts will generally not be includable in the taxable estates of the beneficiaries, will not be subject to creditor's claims, and will not be divisible upon divorce.

Structuring a Transaction as "Installment Sale." Do not structure a transaction as an installment sale assuming all gain will be postponed until cash is received. Although installment sales generally postpone tax recognition of gain until cash is received, that is not true for recapture items (including IDC) which are required to be recognized immediately and are ordinary income.

S Corporation: Built-in-Gain Tax. The built-in-gain tax imposes the highest corporate tax rate on the disposition of assets during the recognition period for any S corporation that was formerly a C corporation. The recognition period is ten years from the first day of the S corporation's first tax year. For purposes of determining the built-in-gain, the assets of the C corporation are valued at the date of conversion from C to S. Thus, if a client has a C corporation that has had a bad year, but the client expects the C corporation to increase in value in the future, electing S corporation status during the "low year" may prove beneficial in the long-run. For example, the client could lock-in a lower built-in-gain on goodwill.

G. ESOP: BASIC RULES AND BENEFITS

An employee stock ownership plan (an "ESOP") is a tax-qualified, defined contribution plan which is "designed to invest primarily in qualifying employer securities."[83] In addition to providing employees with retirement benefits, ESOPs offer several other advantages, including the following:

- Allow the company to borrow money at a lower after-tax cost;
- Incentivize employee productivity;
- Create a ready market for the shares of a privately held company;
- Facilitate tax-efficient succession of the company; and
- Provide significant tax benefits.

[83] IRC § 4975(e)(7).

Basic Rules and Requirements. Although there are many provisions governing the use of ESOPs, the following are some of the basic requirements of utilizing such a plan. ESOPs must satisfy the minimum vesting standards of Section 411 and the minimum participation standards of Section 410(b). Additionally, an ESOP must abide by the annual addition limits laid out in Section 415, which state generally that the annual additions made to each participant's account cannot exceed the lesser of $52,000 (indexed for inflation) or 100% of the participant's compensation.[84] Annual additions include employer contributions, employee contributions, and forfeitures.[85]

Qualified plan participants must have the option to direct the investments of at least 25% of their account.[86] Qualified plan participants are those who have been a member of the plan for at least ten years and have attained the age of 55.[87] The qualified plan participant must be allowed to make the election to direct investments six times. Each time occurring during the first 90 days of the six consecutive plan years beginning with the year in which the plan participant first becomes a qualified plan participant.[88]

In most instances, a plan participant must have the right to receive his distributions in the form of employer securities.[89] Instead of contributing cash to the plan to purchase the securities, the employer may directly contribute securities to the plan without recognizing any gain or loss.[90] Note that it is very important the contributions made to the plan are not made to satisfy an employer's monetary obligation to its ESOP. The Department of Labor has stated in an Interpretive Bulletin that if an employer uses contributions to satisfy monetary obligations to the ESOP, the contribution will be treated as a prohibited transaction, which means that unless it qualifies for one of the exemptions in Section 4975(d), it will be subject to the prohibited transaction penalties.[91]

Voting Rights. If the employer's class of securities is required to be registered under Section 12 of the Securities Exchange Act of 1934 (or a class that would be required to be registered but for an exemption found in Section 12 of such act), then each participant must be allowed to direct the voting for all securities allocated to his account.[92] If the employer's class of securities is not required to be registered, then each participant must be allowed to direct the voting of his allocated shares only for matters which involve the voting of shares in approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as may be prescribed in Treasury Regulations.[93]

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[84] IRC § 415(c)(1).
[85] IRC § 415(c)(2).
[86] IRC § 401(a)(28)(B).
[87] *Id.*
[88] *Id.*
[89] IRC § 409(h)(1)-(2).
[90] IRC § 409(m).
[91] 29 CFR § 2509.94-3.
[92] IRC § 409(e).
[93] *Id.*

If the ESOP holds securities (acquired after 1986) that are not readily tradable on an established securities market, then all valuations of the securities must be performed by an independent appraiser, and the participants must be provided the right to require the employer to repurchase, under a fair valuation formula, the distributed employer securities.[94]

ESOP as an S Corporation Shareholder. Pursuant to Section 1361, an ESOP can hold shares of an S corporation. To prevent abuse of special tax treatment afforded to ESOPs holding S corporation stock (discussed below), there are limitations on the allocations the ESOP can make.

If during any year, "disqualified persons" own 50% or more of the S corporation's stock (including direct, indirect, and constructive ownership), then the ESOP is prohibited from making any allocations to the disqualified persons.[95] Disqualified persons simply means any person who either (1) holds or whose family members hold 20% or more of the S corporation stock, or (2) holds 10% or more of the stock alone.[96] If the ESOP violates the allocation rule, the allocation is treated as a distribution and the S corporation is subject to a 50% penalty tax on the allocation.[97]

Employer securities held by an ESOP must be either: (1) common stock that is readily tradable on an established securities market; (2) if no such common stock exists, common stock that has the greatest voting power and dividend rights; or (3) preferred stock if such stock is convertible, at a reasonable conversion price, into either of such types of common stock.

Dividends. Any dividends paid on stock owned by an ESOP must be reasonable. Although there is no formal definition of what constitutes a reasonable dividend, a review of the IRS ESOP examination guidelines reveals that the IRS will consider such factors as the feasibility of the company continuing to pay similar annual dividends and the extent to which the dividend is a rate normally paid in the ordinary course of business.[98] There are instances in which dividends are tax deductible (see below).

Deduction of Contributions. An employer can, in its discretion, contribute employer securities or cash to the ESOP. The contributions are tax-deductible, but the deduction is limited to 25% of the plan participants' compensation.[99] Any cash contributed to the ESOP can be used to buy company shares or to build up reserves in the plan. It is important to note that this 25% deduction limitation applies to the total contributions paid to all of the company's defined contribution plans. For example, if the plan participants' annual compensation amounted to $5 million, then the company could deduct a total of $1.25 million for all contributions made to all defined contribution plans the company operates.

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[94] IRC §§ 401(a)(28)(c), 409(h).
[95] IRC § 409(p)(1).
[96] IRC § 409(p)(4)(A)(i).
[97] IRC § 4979A(a).
[98] Internal Revenue Manual 4.72.4; IRS PLR 9304003.
[99] IRC § 404(a)(3).

If the employer contributes an amount in excess of the 25% deduction limitation, the amount in excess can be carried over to be deducted in subsequent years.[100] There is, however, a 10% excise tax on the excess amount so contributed.[101]

If the employer is a C corporation, then the corporation itself can take the income tax deduction. If the employer is an S corporation, then the contribution will reduce the profit on which non-ESOP shareholders must pay their income taxes.

The IRS has interpreted Section 404(a)(9)(A) to allow a separate 25% deduction limit for a C corporation's contributions to an ESOP that are used to repay the principal of loan incurred to facilitate the purchasing of "qualifying employer securities."[102] Thus, as long as the IRS continues to use this interpretation, a C corporation can feasibly deduct 50% of the total contributions paid to all of its defined contribution plans.

Additionally, Section 404(a)(9)(B) allows a C corporation to deduct all contributions used by an ESOP to pay interest on a loan incurred to purchase "qualifying employer securities." Although this deduction is unlimited, it is important to keep in mind the fiduciary limitations under ERISA, which means the interest charged to the ESOP must be a reasonable amount.

Pursuant to Section 404(a)(9)(C), the deductions for contributions used toward payment of principal or interest on certain loans do not apply to S corporations.

Deduction of Dividends. C corporations can also take deductions for certain cash dividends paid on company stock held by the ESOP.[103] The corporation can deduct the dividends if any of the following are true: (1) the dividends are paid directly to plan participants or their beneficiaries; (2) the dividends are paid to the ESOP and subsequently distributed to participants no later than 90 days after the plan year in which the dividends were paid; (3) the ESOP uses the dividends to repay a loan incurred by the ESOP to buy the shares on which the dividends are paid; or (4) at the direction of the participants, the dividends are reinvested to purchase company stock.[104] Moreover, a deductible dividend does not count toward the employee contribution deduction limits or the annual addition limits.

Non-Recognition of Gain on Sales of Stock to ESOP. Pursuant to Section 1042, a taxpayer may avoid recognition of long-term capital gain on the sale of employer securities to an ESOP. In order to qualify for nonrecognition, all of the following must be true in regard to the sale:

1. The shares of stock sold must be "qualified securities;"

2. Immediately after the sale, the ESOP must own at least 30% of the employer's stock;

[100] IRC § 404(a)(3)(A).
[101] IRC § 4972.
[102] IRC § 404(a)(9)(A); IRS PLR 20043601.
[103] IRC § 404(k).
[104] IRC § 404(k)(2).

3. The ESOP must agree, in writing, that if the qualified securities are disposed of within three years, the ESOP will pay a penalty tax;

4. The taxpayer must reinvest the proceeds from the sale into other "qualified replacement property" within the "replacement period" (defined below); and

5. There must be election to have Section 1042 apply to the sale.[105]

Any taxpayer can choose to make a Section 1042 election except a C corporation.[106] Additionally, the tax benefits offered under Section 1042 cannot be utilized by ESOPs that have been established by S corporations. Section 1042(c)(1) defines "qualified securities" as employer securities that:

1. Have been issued by a domestic C corporation "that has no stock outstanding that is readily tradable on an established securities market,"

2. The taxpayer did not acquire in a distribution from a qualified pension, profit-sharing, or stock bonus plan or through an exercise of an employee stock option; and

3. The taxpayer has held for at least one year prior to the sale.

The 30% ownership requirement can be met in either of the following two ways:

1. The ESOP owns 30% of each class of outstanding stock of the corporation which issued the qualified securities; or

2. The ESOP owns 30% of the total value of all outstanding stock of the corporation.[107]

"Qualified replacement property" means a stock or debt instrument of a domestic corporation.[108] It cannot be a security issued by the employer that maintains the ESOP or by another corporation within the employer's controlled group of corporations, and it cannot be issued by a holding company.[109] The replacement period "begins 3 months before the date on which the sale of qualified securities occurs and . . . ends 12 months after the date of such sale."[110]

Even though Section 1042 allows the taxpayer to avoid recognition of long-term capital gain on the sale of employer securities, if the purchase price of the replacement property is less

[105] IRC § 1042(a)-(b).
[106] IRC § 1042(c)(7).
[107] IRC § 1042(b)(2).
[108] IRC § 1042(c)(4).
[109] *Id.*
[110] IRC § 1042(c)(3).

than the selling price of the employer securities, then long-term capital gain will be recognized on the difference.

ESOPs as S Corporation Shareholders. Although a qualified trust holding S corporation stock is usually subject to the UBIT, an ESOP is exempted from UBIT rules. Any percentage of ownership of an S corporation that an ESOP holds is not subject to any federal income tax. Thus, if an ESOP owns 100% of an S corporation, there will be no income tax paid on any earnings of the S corporation.

IV. CONCLUSION

The simple truth is that legislation cannot be predicted. What is absolute today could conceivably be different tomorrow. Even though the American Taxpayer Relief Act of 2012 brought some clarity with regard to the future of estate taxes (for now), the new legislation also brought changes such as the net investment income tax. The moral of the story is that no one knows what Congress might spit out next.

Therefore, it is very important to have a thorough understanding of the laws, not only to more quickly comprehend inevitable legislative developments, but also to provide clients with the highest quality of tax planning possible. In some cases, this may mean avoiding certain taxes entirely, and, in other cases, it may mean minimizing tax liability. Regardless, from charitable gifting to the use of trusts to the purchasing of life insurance, there are countless tools available for helping clients, and it is wise to continue to look for new ways to use these tools.