The Wealth Counselor

A monthly newsletter for wealth planning professionals

Income Tax Planning

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The difference between the highest and lowest federal income tax rates is currently 35%. As a result, proactive income tax planning is important for many clients, and it is therefore important to all wealth planning professionals.

This issue of The Wealth Counselor examines basic income tax rules as well as the useful strategies to defer income tax by making installment sales to grantor and non-grantor trusts. It is critical that all wealth planning professionals have a basic understanding of these rules and the ability to recognize the opportunities afforded by these strategies.

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My practice is people oriented and exclusively devoted to estate planning, estate and trust administration, estate and trust litigation, asset protection and business planning. My newsletter highlights wealth planning issues designed as helpful insights to your practice

Income Tax Basics: 4 Critical Questions

When doing proactive income tax planning there are four broad questions all wealth planners should ask:

1. Is it gross income?
   - Can we create tax-free income or cash flow?
2. What is the character of the income?
   - Can we preserve or create capital gain income instead of ordinary income?
3. When is the income reported?
   - Can we defer income reporting to the future?
4. Who reports the income?
   - Can we bracket shift the income to taxpayers in a lower rate bracket (as low as a zero bracket in some circumstances)?

Planning Tip: Tax optimization across multiple tax systems becomes increasingly difficult, and rarely is it possible to maximize on all frontiers, so setting realistic client expectations is the key.

(1) Creating Tax-Free Income or Cash Flow

There are several ways that our clients can generate tax-free income or cash flow:

- Invest in Municipal Bonds
- Borrow against Life Insurance Cash Value
- Take Payments, and thus a Ratable Return of Basis, under Annuity Contracts
- Take Distributions from Roth IRAs and Roth 401(k)s

Planning Tip: Borrowing against life insurance cash value can be an excellent way to generate tax-free cash flow for the right client. However, care must be taken to keep the policy from collapsing and thus causing income recognition.

Planning Tip: Taking Roth IRA and Roth 401(k) distributions will deplete one of the most flexible vehicles for intergenerational wealth transfer. With a taxable estate, drawing down a conventional 401(k) or IRA can result in greater overall tax savings.

(2) The Character of the Income
There is currently a 20% differential between the maximum federal ordinary income tax rate of 35% and the 15% federal income tax rate for long-term capital gain. Given this historically high rate differential, it is very valuable to our clients to both: (1) convert ordinary taxation income into capital gain and (2) preserve capital gain treatment whenever possible.

Planning Tip: It is possible to preserve capital gain treatment for assets the taxpayer anticipates converting into inventory (e.g., by condo conversions or real estate development) through an installment or outright sale to a development entity.

Planning Tip: The historically large federal ordinary income tax versus long-term capital gain rate differential creates opportunities for income tax reduction. (See Volume 3, Issue 2 of The Wealth Counselor). All wealth planning professionals should examine the character of income closely to ensure that clients take advantage of this differential to the extent possible.

(3) Income Tax Timing
Another critical issue is the timing of income. Generally, it is advantageous from a tax perspective to defer income as long as possible. This is because 20 years of income tax deferral is the equivalent of a 90% reduction in the effective tax rate (assuming 12% growth). Given current rates, 20 years of deferral would effectively reduce the present value of the ordinary income tax rate to 3.5% and the capital gains rate to 1.5% (assuming these rates remain static).

For example, Section 1031 tax-free exchanges can defer ultimate reporting of gross income indefinitely or until the replacement property is sold. Should the client hold a particular asset until death instead of selling during lifetime to take advantage of basis step-up? If the client will have a non-taxable estate, the answer is probably different than if the client's estate will be taxable.

Planning Tip: The 15% federal long-term capital gain rate will increase to 20% beginning in 2011 (unless Congress changes the law). As a result, some taxpayers may choose to accelerate tax liability by liquidating assets sooner and/or may opt against tax deferral strategies to take advantage of the current low long-term capital gain tax rate.

Planning Tip: Deferring a $1 million tax liability for 20 years (assuming an 8% cost of capital), results in a tax savings of $785,000, or a tax rate reduction of 78.5%. In other words, the present value of $1 million paid 20 years from today is only $215,000. In addition, the client may be able to generate a healthy income stream from the $1 million during that 20-year period.

(4) Whose Income is it?
Increased life expectancies are making the gift tax far more relevant than the estate tax in many situations. As we help our clients shift assets gift-tax efficiently, we should also counsel them on the ability to shift income tax burdens by transferring assets to family members and other individuals in lower income tax brackets.

Planning Tip: The differential (up to 20%) between the long-term capital gains tax rate between taxpayers with different incomes creates a unique opportunity for income tax reduction by income shifting. (See Volume 3, Issue 2 of The Wealth Counselor.) All wealth planning professionals should examine these possibilities to ensure that their clients take advantage of this differential to the extent possible.

Planning Tip: Be aware of the recently expanded reach of the "kiddie tax." The "kiddie tax" applies the parents' highest marginal rate to a child's unearned income over $1,800, thereby eliminating the tax benefit of transfers made to avoid income taxes or take advantage of lower tax rates. It now covers transfers to all children under 19 and to dependent students under 23. (See Volume 3, Issue 2 of The Wealth Counselor.)

Installment Sales to Trusts
Installment sales to trusts can provide substantial tax advantages. We will examine two scenarios - the installment sale to an irrevocable "grantor" trust and the installment sale to a non-grantor trust.

Planning Tip: Installment sales may not be used to defer income recognition in (1) sales of inventory; (2) dispositions by dealers; (3) sales of publicly traded stock; (4) sales of depreciable property to related parties, including the building portion (but not the land portion) of real estate; (5) the portion of gain attributable to depreciation recapture at ordinary income tax rates; or (6) sales of personal property under a revolving credit plan.

Installment Sale to Irrevocable Grantor Trust
A "grantor trust" is a defined term under the Internal Revenue Code income tax provisions. In a grantor trust, the trust's income is typically attributed to that trust

maker rather than being recognized in the trust or attributed to the beneficiary. With careful design, a grantor trust will be disregarded for *income tax* purposes but effective to remove the trust's assets from the trust maker's estate. In other words, the income tax is borne by the trust maker (and paid for with non-trust funds) but the trust assets are not included in the trust maker's estate for estate tax purposes.

Planning Tip: From the trust's standpoint, this shifting of tax liability is analogous to investing in municipal bonds but earning a corporate bond rate. The trust maker paying the income tax effectively allows the trust maker to make additional transfers to the beneficiaries at no additional gift tax cost.

A typical sale of appreciated property causes imposition of income tax. However, a grantor trust is treated as the trust maker for income tax purposes. Since one cannot "sell" property to oneself, a sale to a grantor trust is ignored for income tax purposes. After the sale, the trust will have as its basis the amount it pays for the property.

This characteristic makes possible an "estate freeze" for assets that are expected to appreciate substantially over time. The technique is for the trust maker to sell the asset to the trust and take back an installment note. Typically the note is interest only for a period of years with a balloon payment at the end plus an unlimited right of prepayment. Code Section 1274 determines the minimum interest rate that the note must bear. Because the trust is disregarded for income tax purposes, interest payments from the trust to the trust maker are not recognized and therefore not taxable.

Planning Tip: If the sale is for less than the full fair market value, the IRS will treat the sale as part sale (the agreed price) and part gift (the amount by which the full fair market value exceeds the sale price).

How does the trust obtain the ability to purchase the assets? One way is by the trust maker making a gift to the trust of "seed" money, often 10% of the value of the assets. Alternatively, able beneficiaries can guarantee the note's payment in a commercially reasonable manner.

To the extent that the financial planning team member can generate a return on the trust assets that exceeds the relatively low Section 1274 rate, the trust maker will have transferred value to the trust without incurring a transfer (gift or estate) tax.

Planning Tip: Consider designing the trust with a "switch" so that it will convert prospectively to a non-grantor trust if the trustee decides to sell the asset before the trust maker's death.

Installment Sale to Non-Grantor Trust
A related technique is to make an installment sale to a non-grantor trust. This technique is used when there is a desire to sell an asset for cash in the future, but also a desire to spread the income over a longer period.

Generally, when one sells an asset for cash he or she must pay income tax on the amount above his or her "basis" in the property. In its most simplified sense, basis is the amount paid for an asset when purchased, or if received by gift, it is the donor's basis in the property.

However, if an installment sale is made to a qualified non-grantor trust and the trust, at least 2 years later, sells the property, the later sale is not collapsed onto the former so the original owner's installment sale treatment is preserved.

Planning Tip: The buyer from the taxpayer must not be a Code Section 1239(b) "related party." Related parties include: (1) entities controlled by the selling taxpayer; (2) trusts as to which selling taxpayer (or spouse) is a beneficiary; and (3) as to beneficiaries of an estate, the executor. However, related parties do not include: (1) the selling taxpayer's children or (2) trusts for the benefit of the selling taxpayer's children.

Planning Tip: The sale out of the trust must be more than 2 years after the sale into the trust.

Here's an illustration of how the numbers can work:

Assume investment real estate with a $2 million sale price, $250,000 basis, and $200,000 of Section 1250 depreciation subject to recapture. With no deferral, the total tax liability equals $282,500 (after-tax proceeds equal $1,717,500), calculated as follows:

Taxable Gain
$2 million - $250,000 Basis = $1,750,000 taxable gain

Tax Rate
25% x $200,000 Section 1250 Recapture = $50,000
15% x $1,550,000 capital gain = $232,500

Suppose instead that the trust maker sold the property to a Kids' Trust for a 20-year installment note, with interest-only payments at 4.21% with annual compounding (the long-term applicable federal rate determined under Code Section 1274(d) for May 2008). The annual interest payments would be $84,200, with a balloon payment due at year 20 of $2,000,000.

If the trust maker invests after-tax proceeds and/or payment streams at 8% and discounts to present value at 3%, and assume that all capital gain is taxed currently at 15% and all ordinary income is taxed currently at 35%:

Present Value of Outright Sale = $4,861,239
Present Value of Installment Sale = $5,156,137, or a $294,898 Advantage

Planning Tip: An additional benefit of installment sales to a qualified non-grantor trust is that $2,636,465 of our present value of the installment sale is inside the trust (after paying a $2 million balloon payment in year 20). These assets will pass to the beneficiaries free of estate and gift tax, and the tax payer can also exempt them from generation-skipping transfer (GST) tax by allocating GST exemption to the trust.

Planning Tip: The bottom line with installment sales is that parents can sell assets to children (or trusts for their benefit) on an installment sale basis irrespective of the related party rules; and the assets can be real estate or a closely held business, but the assets cannot be publicly traded stock. However, if the child (or trustee of the child's trust) resells before 2 years + 1 day have elapsed, the gain will be accelerated and the parents will have to pay tax as though they received sale proceeds on the day of the resale.

Conclusion

Counseling clients on income tax planning strategies is of increasing importance, particularly given the historically large differential between ordinary income and capital gain rates, among other reasons. By working together, the planning team can ensure that clients minimize their overall tax burden and defer taxes as long as possible, all while meeting the client's unique planning goals and objectives.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

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