Income Tax Planning Techniques

The purpose of the following discussion is to apprise the financial advisor of a selected number of personal and business income tax planning methods and ideas. Some concepts, though not directly related to current sales opportunities, are presented on the premise that their timely communication to the client will cement an existing relationship. Other areas will deal specifically with the development of current sales opportunities.

Before looking at the technicalities, we examine three basic planning concepts: diversion, deferral and deduction.

# Personal Planning—Diversion Techniques

Diversion involves shifting income from a high bracket taxpayer to a low- bracket taxpayer.  Gifts, trust arrangements, family partnership and stock ownership vehicles, and private annuities are all diversion techniques.

When individual income tax rates ranged from 11 percent to 50 percent several years ago, diversion was a highly attractive tax-saving technique. However, successive tax acts have condensed marginal rates. Although this rate bracket constriction reduces the benefits of diversion, it does not eliminate them entirely.

Another provision that limits the benefits of diversion is the rule on taxation of unearned income of minors under 18. The so-called kiddie tax was instituted several years ago to prevent the transfer of income producing assets into the names of the taxpayers' minor children in order to divert such income into the lowest rate brackets which would be applicable with respect to such children, who in most cases have no other income. The kiddie tax operates in such a way that unearned income of a minor who has not attained age 18 (and certain full-time students over age 18 but under age 24) by the end of the tax year, to the extent that it exceeds a minimum threshold amount, is taxed at the parents' applicable marginal rate bracket. Unearned income is defined as essentially passive investment income. Obviously, this limits the ability of a parent to save taxes by giving income-producing property to a child.

Despite the reduced benefits of diversion, it will remain an attractive technique for some taxpayers. The following discussion describes some common methods of diverting income from one taxpayer to another.

Income Tax Planning Techniques

Direct Gifts

The gift of an asset, whether it be a security, real estate or other income producing property, will shift to the donee the income which the asset produces. Moreover, if the gift-property has appreciated in value, the gift also shifts potential future taxation of capital gain. Therefore, a gift of appreciated income-producing property may shift both current and future income from a high bracket donor to a lower bracket donee.

A high bracket individual should not sell appreciated assets in order to make a cash gift. The gift should be made in kind with the donee liquidating the gift property and recognizing the gain.

Loss Property

Income-producing property may have a fair market value lower than its basis in the hands of the donor. Should the donor make a direct gift of such property to divert future income to a lower bracket donee? Generally, the answer is no. In this case, the donor should sell the property, realize the loss and use it to offset other income. A cash gift can then be made to the donee. If the property were to be given to the donee and then sold by the donee, the donee would not be entitled to claim a capital loss, since the basis of the property in the hands of the donee cannot be lower than the fair market value at the time of the gift.

Life Insurance

Life insurance gifts generally do not divert income from the donor to a lower bracket donee. The life insurance policy is not producing current income for the donor, unless there is interest earned on dividend accumulations.

Upon maturity or surrender of a policy, the excess of proceeds received over aggregate premiums paid is ordinary income. Therefore, the donor should make a gift in kind. Surrender of the policy, followed by a cash gift to the intended donee is undesirable for the same reasons applicable to a sale-gift of appreciated property.

If it is intended that the policy be held until the insured's death, there are also potentially significant estate tax advantages to making a gift of the policy.

Net Gifts

A net gift is a gift of property by the donor with the gift tax paid by the donee. If the gift property has appreciated substantially, the donee's payment of the gift tax could result in an income tax liability for the donor. The donee's payment of the gift tax liability is

Income Tax Planning Techniques

treated as consideration paid (amount realized) for the transfer of the property. The donor will realize gain if the donee's payment of the gift tax exceeds the donor's adjusted basis for the gift property.  *Diedrich v. Comm'r*, 457 U.S. 191 (1982).

In a net gift situation, should the donor's or the donee's unified credit be used to offset the gift tax? The answer to this question will be very important when the donor and donee make later gifts, and need to know how much of their respective credits remain. The IRS has indicated that the donor's credit must be used.  Ltr. Rul. 7842068. Moreover, the requirement that the donee pay the gift tax will be ineffective as long as the donor has sufficient remaining unified credit to fully absorb the applicable gift tax. The use of the donor's credit against lifetime gifts is mandatory. In Rev. Rul. 79-398, 1979-2 C.B.338, the IRS held that a donor who wished to preserve his unified credit for later use, could not do so by requiring the donee to pay the gift tax with respect to a current gift.

Trust Arrangements

Irrevocable trusts serve the same income-shifting purpose as direct gifts. Income on property transferred to the trust generally will be taxable to the trust or its beneficiaries. The trust provides greater flexibility in that it may be used to plan the income tax consequences at both the grantor and beneficiary levels. (Trusts are discussed in detail in Section 21.)

Interest-Free and Below-Market Loans

The interest-free and below-market loan provisions of the Code require re-characterization of loans in cases where there is serious potential for tax avoidance.  IRC Sec. 7872. Where there is such serious potential for tax avoidance, the parties are treated as if :(1) interest is charged; and (2) the lender made a gift or other payment to the borrower which, in turn, is used by the borrower to pay the interest. A statutory interest rate is provided. Under de minimis rules, loans of $10,000 or less generally are not subject to the provisions, unless a principal purpose of the interest arrangement is the avoidance of any federal tax. A below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any federal tax by either the borrower or the lender. Tax avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan, rather than a loan requiring the payment of interest at a rate that equals or exceeds the applicable federal rate and a payment by the lender to the borrower.

Income Tax Planning Techniques

This provision applies to the following categories of loans:

* Gift loans used to shift income between related taxpayers, such as family loans
* Compensation-related loans used to avoid employment taxes or limits on the deductibility of investment interest
* Corporation-shareholder loans used to re-characterize dividend distributions as deductible interest, or to circumvent other corporate tax rules
* Tax avoidance loans which are other loans if a principal purpose of the interest arrangement is the avoidance of any federal tax

In addition, the Treasury is authorized to promulgate regulations providing for the application of this provision to loans other than those described above. These regulations will apply only in cases in which the interest arrangement has a significant effect on the tax liability of the lender or the borrower. Any loan recharacterized under the regulations will be treated under the general rules, so that interest will be imputed at the statutory rate and, in effect, rebated by the lender to the borrower.

In the case of any below-market loan other than a family loan or a demand loan, the lender is treated as transferring to the borrower and the borrower is treated as receiving from the lender an amount equal to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan. This transfer is treated as occurring on the date the loan is made. In addition, the excess of the amount of the loan over the present value of the payments due is treated as original issue discount. As a result, the lender is treated as receiving interest income at a constant interest rate over the life of the loan. Similarly, the borrower is treated as paying the same amount of interest. The interest that the borrower is treated as paying would be deductible to the same extent as interest actually due on the loan from the borrower. Thus, no deduction would be allowed for interest if the borrower does not itemize his/her deductions for the relevant year or his/her deductions would be disallowed under other provisions of the Code (e.g., Secs. 163(d) or 265).

In family loan and non-family demand loan situations, for purposes of determining the timing and amount of the deemed transfer by the borrower to the lender, term gift loans are treated as demand loans. Term gift loans are treated as demand loans for income tax purposes because, in light of the underlying familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as being binding by the parties. In addition, an original issue discount analysis is required to determine the

Income Tax Planning Techniques

income tax consequences of a term loan. By treating term gift loans as demand loans for income tax purposes, such analysis is avoided.

Thus, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, an amount equal to the forgone interest on an annual basis. For example, assume that on January 1, Paul, a calendar year taxpayer, makes a $200,000 loan to his brother Sam, a calendar year taxpayer, for two years at 5 percent simple interest payable annually. If the applicable federal rate is 12 percent compounded semi-annually, the amount treated as transferred by the lender to the borrower for gift tax purposes would be $24,760 (i.e., the excess of $200,000 over the present value of all payments due under the loan discounted at the applicable federal rate). The amount treated as re-transferred by the borrower to the lender on the last day of each of the two calendar years would be 14,720 (i.e., the excess of interest computed at the applicable federal rate [compounded semiannually] over interest actually payable on the loan). This amount, which would be included in income by the lender and, subject to the rules governing the deductibility of interest, deductible by the borrower, would be in addition to the $10,000 actually due each year under the terms of the loan.

The Code provides authority for the Treasury to issue regulations exempting from this provision classes of loans otherwise subject to the provision if the interest arrangements do not have a significant effect on the tax liability of the lender or the borrower.

Family Business Ownership

The arrangement of ownership in family businesses provides a way to shift ownership and, with it, business income. Two ways to achieve this are the family partnership and the family corporation.

*Family Partnerships.* Since proprietorship or partnership income is taxed directly to the proprietor or partner, the family partnership may be used to divert income among family members.Thus, a sole proprietor may establish a family partnership with his or her children to spread the income across lower rate brackets and to mitigate the overall tax liability. However, the gift or sale of a business interest to another family member may not be sufficient in all cases to achieve the desired shifting of income.

First, the donee or purchaser will be recognized as a partner for income tax purposes if he or she owns a capital interest in a partnership in which capital is a material income-producing factor.  IRC Sec. 704(e)(1). The purpose of this rule is to prevent a mere assignment of income from one family member to another. Such a case exists where partnership income is the direct result of personal services rendered by the donor-partner and capital is not a material income-producing factor. Under these facts, the

Income Tax Planning Techniques

donor-partner would be taxed on all partnership income, regardless of the purported ownership of the partnership interests.

Secondly, where capital is a material income-producing factor, a reasonable allowance as compensation for services rendered by the donor-partner is required.  IRC Sec. 704(e)(2). Thus, for example, although the partnership capital accounts reflect equal percentage interests on the part of the donor and donee, the partnership income may not be divided equally until after it is reduced by an appropriate amount allocable as compensation for the donor-partner's services.

Finally, the transfer of the partnership interest to the donee must be complete. The donee must have absolute dominion and control over the partnership interest with respect to management, distributions and liquidation of the interest.  Treas. Reg. §1.704-1(e)(1)(iii).

The above factors must be considered where the question of splitting a single partnership interest or creating a family partnership is involved.

*Family Corporations.* The family corporation is another potential vehicle for shifting income from one taxpayer to another.

Income is diverted by a transfer of shares from one shareholder to another. The shares transferred to the donee will carry with them future dividends distributed by the corporation. Thus, for example, when a closely held corporation reaches the point where it must distribute dividends or risk being subject to the accumulated earnings tax the situation may call for the transfer of shares to a lower bracket taxpayer prior to any dividend distribution. The financial services professional can generally anticipate this problem if he or she has sufficient information concerning the relative tax brackets of the major shareholder(s) and the corporation.

*Sub S Considerations.* Without going into great detail about the advantages or disadvantages of the S Corporation election, there are some important planning opportunities for the existing electing corporation.

S corporations may have up to 100 shareholders. Thus, in a family situation shares may be distributed among multiple family members. Taxable income of the business will be allocated among them under the S corporation passthrough tax accounting rules. The corporation's income and deductions are allocated among the shareholders on a daily basis according to the number of shares owned on each day of the corporation's taxable year. An equal portion of each item is assigned to each day of the taxable year. The

Income Tax Planning Techniques

portion will be 1/365 except for leap years or short taxable years. The daily portion of each item is then allocated among the shares outstanding each day.

A loss at the corporate level generally makes a transfer of S corporation shares unwise. The S corporation loss flows through directly to the shareholders. Thus, in most cases the high bracket S corporation major shareholder will prefer to take full advantage of the ordinary loss flow through. However, if a transfer of shares is made in the anticipation of profit and a loss does arise, the donor will still be able to utilize the loss based upon the number of days for which the stock was held prior to transfer.  IRC Sec. 1377(a). (S Corporations are discussed in detail in Section 14.1, Subdivision B.)

*Incorporation.* In the past, individual tax rates were materially higher than corporate rates. When that was the case, many people incorporated their business to shift income from individuals to corporations. Individual rates are now somewhat higher than corporate rates. Although incorporation may still be desirable for overall business purposes, it is no longer advisable to incorporate for the purpose of shifting income to the corporation. Shifting dividend income from one individual to another will still be desirable in some cases. Because individual rates are now lower than corporate rates, owners of small corporations should seriously consider converting them to S corporations.

Private Annuities

A private annuity involves the transfer of money or property from one party (the annuitant) to another party (the obligor) in return for a contractual obligation of the obligor to make periodic payments to the annuitant for life. Generally, these arrangement are isolated transaction between private parties who normally don't write annuities.

Where appreciated property is involved, a private annuity fulfills two income tax planning objectives:

* It serves to divert income from the property to the party making the annuity payments (the obligor).
* It allows the seller-annuitant to defer the recognition of gain resulting from exchange of the property for the promise of an annuity.

Although the diversion of ordinary income may be a primary factor in the individual's consideration of a private annuity, future effects of the transaction should not be ignored.

Income Tax Planning Techniques

For instance, future appreciation may be shifted from the high bracket annuitant to the lower bracket obligor. This consideration is of a particular significance where the seller-annuitant has held the particular property for a relatively short time.

An important consideration in the total planning picture for the private annuity is the effect of the transaction on the purchaser-obligor. We are concerned with the obligor's position because he or she is typically a family member for whom the transaction will have different planning ramifications.

Revenue Ruling 55-119 sets forth many of the rules for determining the payor's adjusted basis for purposes of depreciation and gain or loss.  1955-1 C.B. 352. These rules are important for adequate planning of the transaction for both parties. When depreciable property is involved, Revenue Ruling 55-119 established the basic rule that the obligor's basis for depreciation prior to the annuitant's death was equal to the present value of the annuity.

In effect, the obligor is getting a stepped-up basis equal to the purchase price of the property, assuming it is equal to the present value of the annuity, for the purpose of depreciation. Further, the obligor is not necessarily controlled by the rate or method used for depreciation by the transferor. Thus, useful life and method may be determined by the obligor independently of facts relied on by the transferor-annuitant. In many instances, this may allow the obligor to shelter more income via depreciation.

Basis for depreciation is increased by the amount by which the cumulative total of annuity payments exceed the initial value of the annuity.  Rev. Rul. 55-119, *supra*. Thus, the annuity payment is treated by the obligor as a capital expenditure.  See Rev. Rul. 72-81. 1972-1 C.B. 98. This is significant in that it allows the obligor to rebuild the basis which may have been eroded by prior depreciation deductions. This will reduce the gain ultimately realized from a disposition of the property. Upon the death of the annuitant, the basis for computing subsequent depreciation will be the total annuity payments made up to death.  Rev. Rul. 55-119, *supra*. Finally, Revenue Ruling 55-119 requires an allocation where both depreciable and nondepreciable property are transferred. To ascertain the basis for depreciation, the present value of the annuity is multiplied by the ratio of the fair market value of the depreciable property to the property's total fair market value.

Revenue Ruling 55-119 also sets forth the basis rules for determining gain or loss upon disposition of the property by the obligor. The following rules apply:

* If the property is sold after the annuitant's death, the payor's basis for gain or loss equals the total of payments made under the contract.

Income Tax Planning Techniques

* If the property is sold before the annuitant's death, the basis for determining gain equals the total of payments made to date of sale plus the present value of the remaining payments at the date of disposition.
* The basis for determining loss where the property is sold prior to the annuitant's death equals the total annuity payments actually made at the date of disposition.
* Where the property is sold before the annuitant's death and the amount realized is less than the adjusted basis for gain and greater than the adjusted basis for loss, neither gain or loss is recognized.

Recognition of Gain to the Annuitant

Under Rev. Rul. 69-74, 1969-1 CB 43, the annuitant’s gain on appreciated transferred property was recognized "ratably,” i.e. a portion of it was attributed to each annuity payment as generally under IRC Section 72.  Each payment represented in part a return of basis and in part recognized gain. The difference between the annuitant’s basis and the present value of the annuity was recognized as capital gain; after all capital gain was recognized, remaining gain was taxed as ordinary income.

The "ratable recognition" doctrine had its origin in precedents according to which the fair market value of a private annuity could not be calculated because of the uncertainty of payment. That assumption was invalidated by the requirement of IRC Section 7520 that annuities be valued according to IRS tables.  Moreover, the IRS noted that the doctrine was being abused by taxpayers who were deferring or even avoiding recognition of gain inappropriately. Thus, in October 2006 it issued proposed regulations under which:

* the amount realized attributable to the annuity contract is its fair market value (as determined under Sec. 7520);
* the entire gain is recognized at the time of the exchange;
* for purposes of determining the investment in the contract, the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to it (i.e., its fair market value).

As the Preamble to the proposed regulations states, these requirements treat private annuity transactions, with respect to gain on the transferred property, as if the annuitant had sold the property for cash and bought the annuity with the case.

*Sales Opportunities.* The private annuity should be viewed by the financial advisor as a flexible vehicle for the utilization of life insurance products.

Income Tax Planning Techniques

Of particular import is the use of life insurance as a means of funding the obligor's continuing liability should he or she die before the annuitant.

Typically, the annuitant may desire to avoid securing the obligor's promise by a mortgage or other collateral, due to estate tax considerations. Thus, life insurance covering the obligor and payable to his or her estate will enable the estate to meet the obligor's obligations under the annuity contract, without augmenting the annuitant's estate with a lump sum asset. Proper planning for the appropriate amount of life insurance coverage will mitigate the estate tax burden potentially caused by the receipt of the insurance proceeds; the date-of-death value of the continuing annuity obligation is properly deductible by the estate of the deceased obligor.

Savings Bonds

Through the purchase of U.S. government savings bonds, a certain amount of income can effectively be diverted fully tax-free for the payment of a child's higher education expenses. EE government savings bonds have long been used as a safe and convenient way to save for such things as college education. At an investment of fifty percent of the face amount, the bonds will mature in about twelve years. Under IRC section 135 the accrued income from these bonds is tax exempt if the proceeds are used for college educational purposes. This exclusion applies to interest on bonds that are issued after December 31, 1989.

The bonds must be purchased in the name of an individual who is over 24 years of age, and not in the name of the child for whose education the proceeds will be used. Subject to the gross income limitation discussed below, as long as the total amount received in redemption of such bonds in any year does not exceed the qualified higher education expenses paid in such year, none of the income from the redeemed bonds is recognized. Qualified higher education expenses are generally defined as tuition and fees for the taxpayer, spouse or a dependent at an eligible educational institution. If the redemption proceeds exceed the qualified expenses, a pro-rata portion of the income must be recognized. In order to target this tax benefit to those families most in need, the benefit is phased out when adjusted gross income (subject to certain modifications) exceeds an applicable threshold level, which is subject to annual inflation adjustment. (U.S. Savings Bonds are discussed in detail in Section 22.2, Subdivision C.)

Income Tax Planning Techniques

Gift-Leaseback Arrangements

The typical gift-leaseback arrangement involves the transfer of property to an irrevocable trust that leases the property back to the grantor, the grantor claiming a business expense deduction for the payments. Such arrangements are frequently established primarily to shift income (i.e., the rental payments) to trust beneficiaries who are the grantor's children. Income shifting is possible, of course, only if: (a) the trust income is not taxable to the grantor under the grantor trust rules.  IRC Secs. 671-677; and (b) the rental payments qualify for deduction by the grantor as ordinary and necessary business expenses under Code Section 162. The discussion that follows will focus on the deductibility of rental payments.

The Tax Court's test for the deductibility of rental payments in the trust-leaseback situation is that:

* the taxpayer must not retain substantially the same control over the property as he had before making the transfer in trust;
* the lease normally must be in writing and must require a reasonable rent;
* the lease must have a bona fide business purpose, and
* the taxpayer must not possess a disqualifying equity in the trust property within the meaning of Section 162(a)(3).

See *Quinlivan v. Comm.*, 37 T.C.M. 346 (1978), aff'd 44 AFTR 2d 79-5059 (8th Cir. 1979); *Lerner v. Comm.*, 71 T.C. 290 (1978). The first requirement will be met if the trustee is free to enter or not to enter into the lease arrangement with the grantor, and if the trustee is free to negotiate the terms of any lease. Obviously, this requirement means that there must be an independent trustee and that the lease must not be prearranged.  *Van Zandt v. Comm.*, 40 T.C. 824 (1963), aff'd 341 F.2d 440 (5th Cir. 1965), cert. den. 382 U.S. 814 (1966); *Lerner v. Comm.*, supra.

The second requirement is clear enough, but a dispute centers around the third requirement. According to the IRS and the Fourth Circuit, both the lease and the gift in trust must have a business purpose in order for the rental payments to be deductible*.  Perry v. U.S.*, 520 F.2d 235 (4th Cir. 1975), cert. den. 423 U.S. 1052 (1975). In the Fifth Circuit, it must be shown that the whole transaction has an economic reality. This apparently means that the taxpayer's control over the property transferred in trust must be substantially changed by virtue of the trust arrangement.  *Matthews v. Comm.,* *supra*. It seems that the economic reality test may be more difficult to meet than

Income Tax Planning Techniques

the overall business-purpose test, because a gift-leaseback transaction conceivably could have an overall business purpose yet not leave the taxpayer in a substantially changed position with respect to his control over the trusteed property. The Tax Court, however, only requires that the lease have a business purpose.

A business purpose for the lease can be shown if the lease is required for the conduct of the grantor's business or profession.  *Quinlivan v. Comm.*, supra; *Lerner v. Comm.*, *supra*. A business purpose for the gift in trust, however, is more difficult to show. One suggestion is that the transfer in trust can be justified on the grounds of property management where the property in question is leased back, in part, to others besides the grantor. This kind of arrangement should also satisfy the economic reality test.

The fourth requirement is met, according to the Tax Court, even if the grantor retains a reversionary interest in the trust property, so long as the reversionary interest is not derived from the trustee and does not become possessory until the trust terminates.  *Quinlivan v. Comm.*, *supra*.

Tax planners who take the most conservative approach to gift-leaseback arrangements will not be satisfied to meet the minimal requirements of the Tax Court's four-part test. They will want the lease to comply with the economic reality test rather than the business purpose requirement adhered to by the IRS and the Fourth Circuit, and they will want the lease to run for a term shorter than the trust term, so that the trustee will be able at some point to renegotiate for whatever rent is reasonable rather than being locked into a single rent schedule for the entire trust term. Very conservative planning will also dictate that the grantor not retain any reversionary interest in the trust property, so as not to raise the issue of whether the grantor has a disqualifying equity or whether the transaction has an economic reality.

Gift Loanback Transaction

The gift-loanback technique often involves a gift from parent to child, followed by a loan from child to parent. The parent pays interest on the loan, claiming an interest deduction; the child naturally reports the interest received as income. Thus, the gift-loanback technique operates to shift income. Because the Tax Reform Act of 1986 eliminated the deduction for personal interest, this will work only if the loan is for business purposes.

In one case, it was held that the parent could deduct his interest payments if both the gift and the loan were bona fide.  *Cook v. U.S.*, 78-1 USTC 9114 (W.D. La. 1977). Primarily, the bona fide test means that the gift must be genuine, that the parent must indeed have given up the property in question in order to be able to borrow it back. In

Income Tax Planning Techniques

the case at hand, a jury decided that the parent indeed did make a genuine gift to his child.

The downside risk in the gift-loanback transaction seems rather small. If it is determined that there was no genuine gift to the children, then the interest payments will simply be treated as gifts; and unless these payments are hefty, they should fit within the $13,000 ( in 2012, as indexed) exclusion.

# Personal Planning—Deferral Techniques

Deferral involves postponing the receipt of income. The individual plans to receive the income when other sources of income are reduced, resulting in a lower marginal rate. Further, if the taxpayer invests the amount of tax deferred, he can theoretically earn enough to pay the tax at the end of the deferral period. This is sometimes called tax forgiveness.

Common deferral techniques such as executive deferred compensation, qualified employee benefit plans, and deferred annuities are covered in other areas of this Service [see Sections 15 and 17 and Subdivision D of this section, respectively]. The following discussion will cover deferral techniques applicable to individual taxpayers generally in a variety of situations.

When marginal rates ranged from 11 percent to 50 percent deferral was extremely popular. The Tax Reform Act of 1986 lowered marginal rates and reduced the number of brackets. This will reduce or eliminate the attractiveness of deferral for many taxpayers. Individuals with high incomes and substantial assets may remain in the top bracket even after retirement. Other individuals, however, may expect a reduction in income that will put them in the 15 percent bracket. For those individuals, deferral may remain attractive.Code Section 453, in general, requires a taxpayer who sells property and receives the purchase price in installments to spread the recognition of the gain over the installment period.

Reporting gain on the installment basis does not affect the character of the gain as ordinary or capital. If the gain would generally be treated as ordinary income, then it continues to be ordinary under the installment method.

An election can be made not to use the installment method.  IRC Sec. 453(d). To make the election, the entire gain on the sale for the year in which the sale is made is reported on or before the return due date for the tax year of the sale. Generally, a Section 453 election is irrevocable unless permission to revoke is granted by the IRS.

Income Tax Planning Techniques

Installment payments can be arranged any way the taxpayer wishes. For example, a taxpayer could take a lump-sum payment in 2012 and report all the gain in 2012 for a 2011 sale, even though no part of the consideration was received in 2011.

Gain on the sale is determined under the usual rules of Section 1001, i.e., the difference between the amount realized and the property's adjusted basis. The total contract price will generally be the same as the selling price, meaning the amount of cash, notes and other property to be received by the seller. However, where the property is sold subject to a mortgage or a mortgage is assumed by the purchaser, the total contract price will only include the mortgage to the extent that it exceeds the basis of the property sold.  Treas. Reg. §1.453-4(c).

Prior to the Tax Reform Act of 1986 (TRA '86), the installment sale could be used as a tax avoidance device in intra-family situations, particularly in sales between spouses. Husband, for example, would sell appreciated real property to wife, and pay the tax on the gain in installments. Wife, meanwhile, took accelerated depreciation deductions on their joint income tax return against her basis in the property, which was the full purchase price even though she was paying for it in installments. Congress has eliminated this advantage.  See IRC Sec. 453(g).

Under Code Section 453, as amended by TRA '86, a resale of the property by a related purchaser within two years after the original installment sale was made will result in the acceleration of all unreported gain to the original seller in the year in which resale occurs.  IRC Sec. 453(e). The two-year rule applies to all kinds of property except marketable securities; for marketable securities, a resale any time before the installment payments are completed will trigger the acceleration of gain. Marketable securities include any security for which there was a market on an established securities market or otherwise.  IRC Sec. 453(f)(2).

Who, then, is considered a related purchaser? Basically, the same persons that we worry about when we apply the attribution rules in stock redemption situations: (1) the original seller's spouse, children, grandchildren, and parents; (2) corporations or partnerships controlled by the original seller; and (3) estates and trusts of which the original seller is a beneficiary. Brothers and sisters, grandparents, in-laws, cousins, aunts and uncles, and lineal descendants below the grandchildren's generation are not considered related parties for installment sale purposes.  See IRC Sec. 453(f)(1).

Income Tax Planning Techniques

Certain categories of sales and resales are specifically excluded from the acceleration rule. These are (IRC Sec. 453(e)(6)):

* resales occurring after the death of the original seller or the related purchaser;
* resales resulting from certain involuntary conversions (e.g., condemnation);
* certain sales of stock to the issuing corporation; and
* situations in which it is established to the satisfaction of the IRS that neither the original installment sale nor the later disposition had avoidance of the federal income tax as one of its principal motives. Such dispositions might include gifts to charity and like-kind exchanges.

When depreciable property is involved, there is an even stricter rule than the one just described if the related parties are an individual and a corporation or partnership controlled (more than 50 percent ownership) by the individual or corporations and partnerships controlled (greater than 50 percent) by an individual. For purposes of determining control, stock owned by a spouse, brother, sister, ancestor or lineal descendant of the individual is attributed to the individual.  IRC Sec. 453(g). Here, the deferred payments are treated as if received in the year of sale, so that the entire gain must be reported that year.

Closely Held Stock

In the case of a sale by a stockholder, of all of his or her stock back to the corporation, the use of the installment method might be more advantageous than a lump sum redemption. Under Section 302(a) of the Code, a redemption of stock will be treated as a payment in exchange for the stock. This language allows the redeeming shareholder to receive capital gain treatment upon redemption. Unfortunately, the situation is not that simple. Many redemptions will be treated as dividends creating ordinary income unless the complex rules of Section 302(b) are followed.

One safe harbor allows the redeeming shareholder to benefit from capital gain treatment where there is a complete redemption of all stock owned, resulting in a termination of the shareholder's interest.  IRC Sec. 302(b)(3). However, this does not alleviate the problem of having to recognize a large amount of capital gain in a single taxable year. The problem cannot be avoided by a series of redemptions designed to spread the recognition of gain over several taxable years.  IRC Sec. 302(b)(2)(D). A logical alternative is that the stock be sold by the shareholder under a Section 453

Income Tax Planning Techniques

installment sale. The normal installment sale rules would apply to defer the recognition of the capital gain.

Cash-Basis Deferred Payment Sales

Certain deferred payment sales are distinguished from the installment method where the seller is a cash-basis taxpayer and Section 453 does not apply.

Under the so-called cash equivalent doctrine, a deferred payment sale by a cash-basis taxpayer which is not secured by a mortgage, note, or other evidence of indebtedness may result in the nonrecognition of gain until the seller has recovered his adjusted basis.  *Nina J. Ennis*, 17 T.C. 465 (1951). Thus, although the amount of gain is realized in the year in which the property is sold, recognition of the gain is postponed until the seller receives payments exceeding his or her adjusted basis.

The theory is that the existence of the sales contract without the receipt of a mortgage, note, etc.—a cash equivalent—is not an amount realized sufficient to cause recognition of the entire gain in the year of sale. The regulations under Section 453 support this theory by providing that where obligations received by the seller have no fair market value, payments in cash are first applied against the basis of property before gain is recognized.  Treas. Reg. §1.453-6(a)(2). However, it is further noted that only "in rare and extraordinary cases does property have no fair market value."

This rare and extraordinary test is supported by a case which held that the fair market value of the real estate contract itself was an amount realized in the year of sale*.  Warren Jones Co*., 524 F.2d 788 (9th Cir. 1975). In light of the doubt cast on the cost recovery rule, the most prudent path to follow is that of the Section 453 election.

Dealers in Property

In general, dealers in real and personal property may not use the installment method for dispositions of such property.  IRC Sec. 453(b)(2). As a general rule, all payments received from a sale of property by a dealer are treated as received in the year of disposition. To achieve this result, Code Section 453 defines the term installment sale to exclude any dealer disposition.  IRC §453(b)(2). A dealer disposition is defined a: (1) any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan; or (2) any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.  IRC Sec. 453(l)].

Income Tax Planning Techniques

Dealers may use the installment method for sales that do not fall into the category of dealer dispositions. A dealer disposition does not include a disposition on the installment plan of any property used or produced in the trade or business of farming within the meaning of Code Section 2032(e)(4) or (5). At the election of the taxpayer, dealer disposition will not include dispositions in the ordinary course of the taxpayer's business to an individual of: (a) a timeshare right to use, or a timeshare ownership interest in, residential real property for not more than six weeks per year, or a right to use specified campgrounds for recreational purposes; or (b) any residential lot, but only if the taxpayer or a related person is not to make any improvements with respect to such lot. Timeshares in property held by the spouse, children, grandchildren or parents of an individual are treated as held by such individual. In order for the installment method to apply to dispositions of timeshares or residential lots, the taxpayer must make an election which includes agreement to pay interest, at the applicable federal rate, on the deferred tax payments for the period from the date of sale to the date of receipt of each respective installment.  IRC Sec. 453(l)(3). If an installment obligation is guaranteed by any entity other than an individual, the election for installment reporting for timeshares or residential lots is not available.

Finally, a dealer may use the installment method for occasional dispositions of personal property that is not stock in trade.

Interest Required on Larger Sales by Nondealers

IRC Section 453A imposes a requirement that interest be paid with respect to tax amounts deferred by nondealers using the installment method when the sales price of the property sold exceeds $150,000, but only if the face amount of all such installment obligations which arose during, and are outstanding as of the close of, the taxable year exceeds $5,000,000. The interest rate is based on the rate applicable under IRC Section 6621(a)(2) with respect to underpayments of tax.  IRC Sec. 453A(c). To determine if the Section 453A $5 million threshold has been exceeded for the tax year, all persons treated as a single employer for purposes of Code Section 52 are considered one person.

The interest requirement is not applicable with respect to nondealer dispositions of property used in the trade or business of farming or personal use property as defined in IRC Section 1275(b)(3). This refers in general to property not substantially used in an investment activity or in connection with the taxpayer's trade or business.

Income Tax Planning Techniques

Pledges of Installment Obligations

If any indebtedness is secured by a nondealer installment obligation, the net proceeds of the secured indebtedness are treated as a payment received on the installment obligation on the later of the date that the indebtedness is secured or the date that the net proceeds are received by the taxpayer.  IRC Sec. 453A (d). The amount treated as a payment may not exceed the excess of the total contract price over any payments received under the contract before the secured indebtedness was incurred.

Imputed Interest

Code Section 483 requires that interest be imputed in connection with certain deferred sales contracts which do not provide for interest, or an adequate rate of interest, with respect to deferred payments. Interest will be imputed with respect to payments due more than six months after the date of the sale or exchange, if any part of the payments is due more than one year after such date.  IRC, Sec. 483(c). Thus, if such an installment sales contract does not provide for interest, or provides interest at a rate less than the applicable federal rate under Code Section 1274(d), each payment will be subject to allocation so that a portion is treated as interest at the applicable federal rate.

It should be noted that in computing the gross profit ratio, for purposes of the mechanics of measuring the portion of each installment payment which is to be treated as income from the sale, amounts which are treated as imputed interest under Code Section 483 reduce the amount of gross profit from the sale itself.

Estate and Gift Tax Savings

Although installment sales are usually thought of as providing income tax deferral, an intra-family installment sale also has potential for estate tax savings. While the unpaid installments will be included in the seller's gross estate at fair market value, the seller's gross estate will not include any post-sale appreciation in the value of the transferred property. Thus, an installment sale is an excellent way to transfer to a family member property that is likely to appreciate.

To the extent the installment obligation is included in the seller's gross estate, it represents income in respect of a decedent. A beneficiary of the estate who receives the obligation will continue to report the deferred gain on the obligation in the same manner as the decedent. The beneficiary, moreover, will be able to claim an income tax deduction for the estate tax attributable to the obligation.  IRC Sec. 691(c).

Income Tax Planning Techniques

Note, however, that a seller's estate makes a taxable transfer of an installment obligation if the obligation is transferred to the obligor by bequest, devise or inheritance. A taxable transfer also exists if the estate allows the obligation to become unenforceable.  IRC Sec. 691(a)(5). If the decedent-seller and obligor are considered related persons under Code Section 453(l), then the fair market value of the obligation must be treated as not less than its face amount.  IRC Sec. 691(a)(5)(B). For these purposes a related person includes a spouse; child; grandchild or parent; controlled corporations and partnerships; and trusts and estates.

An intra-family installment sale also can be used to effect gift tax savings. One popular technique in this regard is for a parent to sell property to a child under an installment sale contract, taking back a series of notes that fall due at yearly intervals. As the notes fall due, they are canceled in whole or part, giving rise to gifts that often fall within the $13,000 (in 2012, as indexed) annual gift tax exclusion. Thus, if the transaction works as intended, the parent is able to transfer the property to his child yet avoid making any (adjusted) taxable gifts or using his unified gift tax credit.

The Tax Court, in *Estate of Kelley v. Comm'r*, 63 T.C. 321 (1974), nonacq., 1977-2 C.B. 2, permitted this kind of arrangement to work as intended. But in Rev. Rul. 77-299, 1977-2 C.B. 343. the IRS held that it would treat the sale as a gift (and disregard the forgiveness of each note) if "as part of a prearranged plan" the parent intended to forgive the notes as they fell due.

Private Annuities

The use of the private annuity to divert income has already been discussed. However, where appreciated property is involved, the private annuity is likewise a deferral mechanism.

The private annuity defers income because the gain is recognized ratably over the term of the annuity. The period over which the capital gain is reported is based upon the initial life expectancy of the annuitant. Thus, with a life annuity, capital gain will be reported until the expiration of the annuitant's life expectancy. After that time, the taxable portion of the annuity will be all ordinary income.

The result might be different, however, if the private annuity arrangement is secured. In a split decision of the Tax Court it was held that if the property transferred is in exchange for a secured private annuity, any gain, measured by the excess of the present value of the annuity over the annuitant's adjusted basis in the property, is realized in the year of exchange.  *Est. of Lloyd G. Bell*, 60 T.C. 469 (1973). A similar result was reached in 212 *Corp. v. Comm*., 70 T.C. 788 (1978), also a split decision.

Income Tax Planning Techniques

Accordingly, in planning a private annuity transaction in order to achieve deferral of recognition of unrealized appreciation, due consideration must be given to these Tax Court cases. Security of the annuity obligation may have to be sacrificed in order to effectively achieve deferral.

Timing Income and Expense

Most individuals, as cash taxpayers, have the opportunity to defer income and expense to secure the optimum tax benefit from such items.

Much of the planning in this area involves forecasting of the taxpayer's year-end position to see whether or not income or expense should be recognized in the current tax year or, if possible, deferred to a future taxable period.

A simple example will illustrate this. An unmarried individual has adjusted gross income of $30,000. In December, the last month of his 2011 taxable year, he receives a hospital bill for $500. This is the only medical expense he has for 2011. Since deductibility of medical expenses is subject to a 7.5 percent of adjusted gross income limitation ($2,250 in this case), the bill should be not be paid until after the end of the year. Payment in 2011 will afford no tax benefit, while payment in 2000 may be more beneficial since it can be combined with other medical expenses in that year, with the chance that the 7.5 percent limitation might be then be exceeded.

Under the same facts, suppose that the hospital bill received is for $5,000 and the taxpayer expects his income to decline significantly in the following year, so that his marginal rate bracket will be reduced from 28 percent to 15 percent. The taxpayer may be well advised to pay the bill in full before the end of 2011, and claim the deduction in that year.

Constructive receipt considerations must be taken into account when planning the deferral of income. Thus, in high income years, year-end transactions should be structured so that receipt of income is subject to "substantial limitations or restrictions." Treas. Reg. §1.451-2(a). If such restrictions or limitations are not eliminated until a future tax year, the income need not be recognized until such future year.

# Deferred Compensation

Under a deferred compensation arrangement an employer agrees to pay an employee compensation in the future—usually at retirement—for services the employee renders currently. There may also be ancillary benefits in the form of payments to the employee's surviving spouse or other beneficiary in the event of the employee's death

Income Tax Planning Techniques

prior to or after retirement, and payments to the employee in the event of disability. The arrangement generally has a twofold objective: on the part of the employer, to attract and retain key employees; on the part of the employee, to receive additional compensation, possibly at a time when his or her tax bracket will be lower, thereby resulting in higher after-tax compensation.

Deferral of taxation of compensation involves concern with the tax doctrines of constructive receipt and economic benefit.

# Personal Planning—Deduction Techniques

The major items of deduction, both above-the-line deductions in arriving at adjusted gross income, and itemized deductions in arriving at taxable income, have already been covered in this Section. The following discussion will explore some of the more unusual, and frequently overlooked, items of deduction within the major categories.

Medical Expenses

An individual can take an itemized deduction for expenses paid during the tax year for medical care to the extent that such expenses exceed 7.5 percent of adjusted gross income. The deduction, however, is limited to unreimbursed medical expenses.  IRC Sec. 213(a). The primary test for whether an item constitutes a deductible medical care expense is stated in Section 213(d). Under Section 213(d)(1)(A), the term "medical care" includes amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body. This test is broad enough to cover items which may not, at first glance, appear to be related to medical care.

A typical example is provided by a Revenue Ruling which allowed the cost of a clarinet and music lessons as a viable medical expense.  Rev. Rul 62-210, 1962-2 C.B. 89. The patient's orthodontist recommended the music lessons to correct the growth of teeth. The key to taking advantage of such items is simply obtaining sufficient information about the underlying facts and adequately documenting the medical necessity.

Items such as transportation and lodging expenses may be allowable medical deductions. Where transportation expenses are concerned, the actual cost of going to and from the source of medical treatment is deductible under Section 213(d)(1)(B). The IRS publishes each year a standard rate per mile which may be used in lieu of the deduction of actual auto expenses. Parking fees and tolls may be deducted in addition to the standard mileage amount. A medical expense deduction is also permitted for lodging, but not meals, while away from home primarily for and essential to receiving

Income Tax Planning Techniques

medical care. The lodging deduction is limited to amounts that are not lavish and cannot exceed $50 per night for each individual.  IRC Sec. 213(d)(2).

Transportation expenses of persons other than the patient are likewise allowable medical deductions in certain cases, e.g., nurse traveling with heart patient and parents traveling to visit institutionalized child.  Rev. Rul. 58-110, 1958-1 C.B. 155; Rev. Rul. 58-533, 1958-2 C.B. 108.

The cost of special education or schooling, including meals and lodging, is likewise a valid medical expense.  Treas. Reg. §.1.213-1(e)(1)(v)(a). A private letter ruling (PLR 200521003, March 1, 2005; released May 17, 2005) appears to require a diagnosis of the condition the special education is meant to correct, and notes that the criterion for deductibility is the special education provided, not the institution providing it ("a school can be 'special' for one student but not for another").

Most capital expenditures are not currently deductible.  IRC Sec. 263. However, a capital expenditure may be currently deductible as a medical expense.  Treas. Reg. §1.213-1(e)(1)(iii). Thus, items such as wheel chairs, air conditioning units for asthmatics, and in-house elevators for handicapped people or heart patients may be currently deductible. If a permanent improvement to property, such as an elevator or a central air system is installed, it is currently deductible as a medical expense only to the extent that the expense exceeds the increase in value of the related property.  Treas. Reg. §1.213-1(e)(1)(iii). Of course, the expenditure itself must be related directly to medical care.

Real Estate Taxes

In connection with the deduction for real estate taxes, one area that is frequently overlooked or completely mishandled by many individuals is the Section 164(d) rule for the allocation of real estate taxes between seller and buyer.

When real property is sold, the apportionment of taxes between buyer and seller is required under the Code regardless of the actual apportionment of taxes or the parties' method of accounting—cash or accrual.  Treas. Reg. §1.164-6(d).

Under Section 164(d), the seller deducts that part of the real estate taxes properly allocable to the part of the real property tax year which ends on the day before the date of sale; the buyer deducts the taxes allocable to that part of the real property tax year beginning on the date of sale.  IRC Sec. 164(d)(1). A real property tax year is defined as the period which is "regarded as the period to which the tax imposed relates under local

Income Tax Planning Techniques

law." Treas. Reg. §1.164-6(c). Where both a state and county impose real estate taxes, the real property tax year for each tax must be determined in applying Section 164(d).

*Example.* State X uses the calendar year as its real property tax year. Under state law, the tax becomes a personal liability of the owner of real property on 6-30 of the current real property year, 2011, but is not payable until February 28 of the following property tax year, 2012.

S owns realty in state X and sells it to P on May 30, 1999. P thus becomes liable for the 2011 real estate tax payable February 28, 2012. The amount of the tax is $3,000. What may S and P deduct and when is it deductible?

First, S may obviously deduct the 2010 real estate taxes which would have been paid by him by February 28, 2011. In 2011, S may also deduct 149/365 of the real estate taxes payable by P in 2012. S is treated as having paid the allocable tax (for the period January 1 through May 29, 2011) on the date of the sale.  IRC Sec. 164(d)(2)(A).

P will deduct 216/365 (May 30 to December 31, 2011) of $3,000 in 2012, when the tax is actually paid.  Treas. Reg. §1.164-6(d)(4), Example (1). If S had failed to observe the rule of Section 164(d) because he did not, in fact, pay any of the tax for which P was liable, he would have overlooked a deduction of $1,225 (149/365 x $3,000). On the other hand, the seller's portion of the taxes payable by the buyer are typically reflected upon the settlement statement as a charge against the seller's proceeds from the sale, and can easily be picked up for inclusion in the seller's tax return (along with other possible deductions) if the settlement statement is examined carefully as part of the assembly of data for preparation of the return.

Charitable Deductions

Planning in this area is complex, due to the various percentage limitations applicable, certain issues involving determination of the year of payment, and the utilization of the 5-year carryover for gifts in excess of the percentage limitation.

First, the deduction limitation for most contributions by individuals is 50 percent of adjusted gross income.  IRC Sec. 170(b)(1)(A). If this limitation is exceeded, the excess may be carried over for 5 succeeding taxable years.  IRC Sec. 170(d). The problem becomes one of determining the tax benefit to the individual in the year of contribution compared to any advantage or disadvantage that might result from carryover. Thus, it is possible to lose the carryover where current "50 percent gifts" in subsequent years equal the maximum contribution limitation.

Income Tax Planning Techniques

Time of Deduction

The issue of the year of payment of the contribution has been a continuing problem for cash-basis individuals. For a contribution of property other than cash, the general rule is that delivery to the charity must be complete in the year for which the contribution is claimed. In the case of a cash donation, there must be actual payment by a cash-basis taxpayer.

Delivery of a demand promissory note does not constitute actual payment in the year in which the note was delivered.  *Guren v. Comm.*, 66 T.C. 118 (1976). However, a contribution made by credit card is deductible when the charge is made, regardless of when the cardholder donor pays the charge.  Rev. Rul. 78-38, 1978-1 C.B. 67.

Substantiation and Disclosure Requirements

Income tax deductions are not allowed for charitable contributions of $250 or more unless the donor obtains a written substantiation from the charity.  IRC Sec. 170(f)(8); Treas. Reg §1.170-13(f). If a donor makes separate donations, these will be considered independent contributions and will not be aggregated for purposes of measuring the $250 threshold. The IRS is, however, authorized to create anti-abuse rules to prevent avoidance of the substantiation requirement by taxpayers writing separate checks on the same date.

The donor is responsible for obtaining the written acknowledgment because charities are not required to report this information to the IRS. An acknowledgment must be received no later than the date the donor's tax return is filed or the due date of the return with any extensions.

Although there is no prescribed format for the written acknowledgment, the IRS does require that certain information be included.  Treas. Reg. §1.170A-13(f)(2). For example, the acknowledgment must state the amount of the cash or check contribution. If property is donated, the acknowledgment must describe, but need not value, such property. In addition, the charity's letter should state whether it did or did not provide any goods or services in exchange for the donation. If anything was given to the donor, the charity must describe and provide a good faith estimate of the value of the goods or services.

Income Tax Planning Techniques

Charities receiving quid pro quo contributions exceeding $75 are required to give a written disclosure letter to the donor: (a) explaining that the amount of the contribution which is deductible for federal income tax purposes is only the excess of the contribution over the value of any goods or services received by the donor from the charity as a result of the gift; and (b) stating a good faith estimate of the value of such goods or services.  IRC Sec. 6115. For example, if a donor gives a charity $100 and becomes entitled to a dinner valued at $40, the charity must inform the donor that the dinner was valued at $40, and that only $60 would be deductible. Because the donor's quid pro quo contribution exceeds $75, the charity must furnish a disclosure statement, even though the net deductible amount is less than $75.

If a charity does not comply with the disclosure requirements, a $10 penalty per contribution will be imposed. Such penalties cannot exceed $5,000 per fundraising event or mailing. The charity can, however, avoid being penalized if it can prove that its noncompliance was due to reasonable cause.  IRC Sec. 6714.

Election of 50 Percent Limit

Contributions of long-term capital gain property are subject to a limitation of 30 percent of the taxpayer's contribution base (essentially, 30 percent of adjusted gross income). However, the taxpayer may elect to reduce the amount of the contribution by that part which would have been long-term capital gain and apply the higher 50-percent-of-adjusted-gross-income limit.  IRC Sec. 170(b)(1)(C).

Although a later year carryover deduction may be lost, a greater current year deduction may be secured. This is illustrated in the situation where D, a donor, contributes securities with a fair market value of $30,000 to charity. The securities have a basis to D of $28,000, and the profit would be long-term capital gain if the securities were sold. D's adjusted gross income for the year of contribution is $50,000.

The amount of D's charitable contribution is $30,000, the fair market value of the securities. Without the above election, D's charitable deduction is limited to $15,000 (30 percent x $50,000) in the year of the contribution. The remaining $15,000 may be carried over to D's following 5 taxable years subject to the 30 percent limitation in each carryover year.

Income Tax Planning Techniques

If D were to make the election to apply the higher 50 percent limit, he will have a charitable deduction of $25,000 in the year of contribution:

|  |  |
| --- | --- |
| 1) Amount of contribution  | $30,000 |
| 2) Reduced by long-term capital gain | $2,000 |
| Contribution | $28,000 |

By electing to forego the deduction of the long-term capital gain, and qualify for the 50 percent ceiling, the deduction in the contribution year is increased from $15,000 (30 percent of the $50,000 AGI) to $25,000 (50 percent of AGI). Because the reduced amount of the contribution ($28,000) exceeded 50 percent of adjusted gross income, the carryover rule of Section 170(d) applies ($3,000 is carried over).

This election may be of particular significance in the case of a decedent's final individual income tax return. Since any contributions in excess of the 30 percent limit may not be carried over by his estate, the election may be made to create a final, larger deduction for the final income tax return.

Where the election is made, carryovers of contributions of capital gain property from prior years when the election was not in effect will be treated differently. Thus, in the year in which the election is made, prior year carryovers will be reduced and the higher 50 percent limit applied as if they were originally subject to the election.  IRC Sec. 170(b)(1)(C)(iii).

Bargain Sales

Many individuals operate under the mistaken assumption that appreciated property may be sold to charity for its basis without recognition of gain by the seller. The property's basis must be allocated between the sale and gift portion.  IRC Sec. 1011(b). Thus, gain will be recognized in most instances.

To determine the basis for the purpose of computing the seller-donor's gain, the adjusted basis is multiplied by the ratio of the amount realized to the property's fair market value.  Treas. Reg. §1.1011-2(b).

Assume that S sells property to C, a qualified charity, for $4,000. At the time of the sale, the property is worth $10,000 and has an adjusted basis of $4,000. A's charitable contribution is $6,000 ($10,000 - $4,000). A recognizes gain of $2,400 as follows:

Income Tax Planning Techniques

|  |  |
| --- | --- |
| 1) Amount realized  | $4,000 |
| 2) Adjusted basis: | $4,000 x $4,000 = $1,600$10,000 |
| 3) Gain recognized | $2,400 |

Thus, the net effect of the sale would be a charitable deduction of $6,000 and a long-term capital gain of $2,400.  Treas. Reg. §1.1011-2(c), Example (1).  Because a gift of capital gain is involved in part, the charitable deduction contribution limit is reduced to 30 percent of adjusted gross income.  IRC, Sec. 170(b)(1)(C)(i).

The above example for determining gain in a bargain sale transaction may be expressed by the following formula:

|  |  |  |
| --- | --- | --- |
| Gain = | Amount realizedFair market value | X (Fair market value — Basis) |

Contributions of Life Insurance

The rules concerning the charitable deduction of life insurance gifts are covered in detail in Section 8, Subdivision E.

Planning the deduction is generally no problem where an absolute assignment of the policy is contemplated, i.e., the transfer will avoid the partial interest problem created by Section 170(f)(3). But, even with an absolute assignment, the amount of the deduction may vary.

This variance is due to the characterization of life insurance as ordinary income property, and the rule that a charitable contribution deduction amount may not include any unrealized gain element which is other than long-term capital gain.  IRC Sec. 170(e)(1)(A). Gain on the sale or exchange of a life insurance or endowment contract is taxed as ordinary income. Gain is realized when the amount received under such contract exceeds aggregate consideration paid.  IRC Sec. 72(e)(2)(B). Hence, under Section 170(e)(1)(A), the amount—fair market value—of a life insurance policy donated to charity is reduced by the amount of ordinary gain realizable as if the donated property had been sold.

Income Tax Planning Techniques

Therefore, the contribution deduction for a life policy with a fair market value in excess of basis is effectively limited to the adjusted basis of the policy.

Where the policy's basis exceeds its fair market value (as it will in the early years of the policy), the amount of the charitable contribution is the policy's replacement cost. In any event, the 50 percent of adjusted gross income limit applies.

An endowment policy is treated differently when it is transferred by the donor in the year of maturity. With an endowment policy, the donor will recognize gain as ordinary income in the year of maturity and then claim the maturity value of the contract in full as a deduction. This has the same effect as if the charitable deduction were limited to the donor's adjusted basis in the contract.

The major planning problem for gifts of life insurance to charity is the retention of an interest in the policy by the donor. The retention of an interest by the donor without a proportionate sharing of the retained interest by the charitable donee disallows the charitable deduction for the policy transfer.  Rev. Rul. 76-143, 1976-1 C.B. 63; see also Rev. Rul. 76-1, 1976-1 C.B. 57.

Where the donor desires to make an irrevocable assignment of the cash value of a paid-up policy to charity, while retaining the right to designate the beneficiary of the amount at risk, a policy loan arrangement is a better planning approach. The insured would borrow funds equal to the cash value; the cash would in turn be donated to the charity. Thus, the income tax deduction is secured in an amount equal to the cash contribution. Later interest payments on the policy loan would not be deductible since the loan was for personal (i.e., not business) purposes.

From an estate tax standpoint, the loan arrangement provides virtually the same treatment as the irrevocable assignment to charity in that the proceeds potentially subject to tax are reduced by the loan previously withdrawn by the insured donor. The loan proceeds will not be income to the donor unless cash value withdrawn exceeds the aggregate premiums paid.

Premiums

If a policy is irrevocably assigned to charity, subsequent premium payments by the donor will be deductible as charitable contributions. However, there is some question as to the contribution limitation applicable to subsequent premium payments.

Income Tax Planning Techniques

The contribution of the policy to charity will qualify for the 50 percent limitation of Section 170(b)(1)(A). This is because the contribution is made directly to the charity. However, if the donor continues paying such premiums directly to the insurer, there is an argument that such payments are not to the charity but for the use of charity. If the "for the use of" test applies, the contribution limitation is 30 percent of adjusted gross income.  IRC Sec. 170(b)(1)(B).

Authority for the position that payments to the insurer cause application of the 30 percent rule is scant. There appears to be no case dealing precisely with the issue of premium payments.

In a  case, the Rockefeller family successfully challenged the 30 percent (then 20 percent) limitation on deductions of unreimbursed expenses by volunteers. The IRS argued that that these expenses were not contributions made to the charities, but were made for the use of the charities, because the cash to pay the expenses was not paid directly to the charities. The Tax Court held that the distinction turned on whether the charity received an immediate or delayed benefit from the contribution. The out-of-pocket expenses incurred by the Rockefellers immediately benefited the charities, the court reasoned, and were therefore contributions to charity*.  Rockefeller v. Comm.*, 76 T.C. 178 (1981). The United States Court of Appeals for the Second Circuit affirmed the Tax Court decision that unreimbursed expenses were gifts to charity.  *Rockefeller v. Comm.*, 676 F2d 35 (2nd Cir. 1982). The court reviewed the history of the distinction between gifts to and for the use of charity, and concluded that for the use of meant in trust for. Congress intended less favorable treatment for gifts in trust, since such contributions often do not reach the charitable beneficiaries for a long period of time, reasoned the Court. The IRS eventually acquiesced in this decision.  Rev. Rul. 84-61, 1984-1 C.B. 39. What is the impact of this decision upon other gifts thought to be for the use of charity? Payment of insurance premiums, mortgage payments or other debts owed by charity provides charity with an immediate benefit—release from the obligation to make the payment. Since such gifts provide an immediate benefit, and are not in trust, they should qualify as gifts to charity.

To be on the safe side, the donor-insured, having transferred the policy itself, might make cash contributions directly to the charity in the amount of the premiums. The charity may then pay the insurer. This method will insure the higher 50 percent limitation.

Income Tax Planning Techniques

Casualty Losses

The $100 floor for individual casualty losses and the 10-percent-of-adjusted-gross-income floor for aggregate casualty losses apply only to nonbusiness property.  IRC Secs. 165(c)(3), 165(h). Thus, where property which is used partly for business and partly for personal purposes is destroyed and a loss results, the $100 floor and the 10 percent of AGI floor will apply only to the personal portion of the loss. Moreover, the business portion of the loss must be allocated since it is deductible from gross income, whether or not the taxpayer itemizes deductions.

Different rules apply in determining the loss for the complete destruction of property used for both personal and business purposes. The loss attributable to the personal use portion is the lesser of: (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property.  Treas. Reg. §1.165-7(b)(1).

On the other hand, the total destruction of the business portion of the property will result in the adjusted basis in the property being treated as the amount of the loss, if the fair market value of such business portion immediately before the casualty is less than its adjusted basis.  Treas. Reg. §1.165-7(b)(1).

*Example.* A owns a car which he purchased for $3,500. A uses the car 2/3 for business and 1/3 personally. A's basis for depreciation is $2,333, and he has owned the car for one year when it is destroyed by fire. No insurance is involved. Before the fire, the car had a fair market value of $2,000 and immediately afterwards a scrap value of $100.

|  |
| --- |
| (1) Personal casualty loss:  |
|   | (a) Value before (1/3 x $2,000)(b) Value after (1/3 x $100)(c) Loss (not in excess of basis)(d) Less: $100 floor(e) Itemized deduction | $667$33$634$100$534 |
| (2) Business loss: |
|   | (a) 2/3 of cost (basis)(b) Less: 1 year’s depreciation (3 years, straight line)(c) Adjusted basis(d) Fair market value before (2/3 x $2,000)(e) Casualty loss | $2,333$778$1,555$1,333$1,556  |

Income Tax Planning Techniques

The application of the proper business loss method, along with personal business use allocation, results in a greater casualty loss than under the personal casualty loss method.

Other Deductions

One deduction which is frequently lost due to poor tax planning relates to the termination of an estate.

The beneficiaries of the estate are entitled to an itemized deduction for unused losses of the estate or its excess deductions on termination.  IRC Sec. 642(h). Every individual fiduciary should be advised of this provision in order to time distributions and payment of estate expenses, as well as deciding when certain electable deductions should be claimed.  See IRC Sec. 642(g). More importantly, the deduction allocable to a beneficiary under Section 642(h) may be of no use if his or her aggregate deductions are insufficient to itemize. This problem can be avoided by distributing property which has a carryover basis in excess of its fair market value, rather than having the estate sell the property. The beneficiary may then sell the property, using the loss on his or her personal return as a deduction from gross income, even if he or she does not itemize.

# Tax Shelters

Many of the income tax planning techniques already discussed constitute tax shelters in themselves. The following discussion will examine some formal tax shelter arrangements, their methods of operation, and the planning principles involved. The effectiveness of traditional tax shelters, however, was severely limited by the Tax Reform Act of 1986.

The broad purpose of a tax shelter is implicit in the descriptive term itself. Quite simply, the idea is to shelter income from taxation using one or more of the tax planning principles previously discussed. In general, an investor seeking tax shelter is looking for relief in the form of deferral, tax deductibility, or perhaps capital gain treatment. When seeking a tax shelter, it is important to consider the underlying economics of the transaction. Tax considerations alone should not motivate an investment.

Although characteristics of a tax sheltered investment may vary depending on the form and type of the vehicle employed, several common features can be identified.

*Leverage.* This refers to the maximization of investment return through the use of borrowed capital. Interest deductions offset current income, subject to the investment interest limitations discussed in Subsection B of this section.

Income Tax Planning Techniques

*Depreciation and Depletion.* The tax shelter vehicle, such as an equipment leasing venture, may use the accelerated cost recovery system or accelerated depreciation with respect to the cost of the property. This is true even though all or part of the cost of the asset has been financed by other parties.

A depletion deduction may be available for an investment in natural resources such as oil, gas, timber and minerals. Although deductions for depreciation and depletion may create a loss from a tax standpoint, the investment's cash flow may still be positive. Thus, the investor may benefit from both a currently deductible loss and the receipt of cash flow for other investment or business endeavors. *Deferral.* If an investment is made in venture which initially operates at a loss, the loss may be available to shield other income from current taxation. The tax liability is effectively deferred to later years when the investment is producing income.

Timing is important in this regard to avoid having deferred income taxed at a steeper rate in a later taxable year. Obviously, it is desirable that deductions materialize in current high-income years while gain or investment income is realized in later low bracket years.

Losses from Passive Activities

If deductions and credits from so-called passive activities exceed income from those activities, they may not be used to offset other income.  IRC Sec. 469. Losses and credits disallowed under this rule (suspended losses) may be carried forward. When a taxpayer disposes of his entire interest in an activity, any remaining loss is allowed in full.

A passive activity is a trade or business in which the taxpayer does not materially participate. A person materially participates in an activity only if he is involved in the operations of the activity on a regular, continuing and substantial basis. A limited partnership interest is, by definition, a passive activity, because limited partners are not allowed to participate in operations. However, other forms of ownership, such as proprietorships, general partnerships or S corporations, may also be passive activities.

Rental activity is considered passive activity regardless of the taxpayer's degree of participation. Rental activities include leasing of both real and personal property. Losses from rental activities may be deducted against income from other passive activities but not against other income, except pursuant to the partial exception discussed below.

Income Tax Planning Techniques

Exception for Working Interests in Oil and Gas Property

The passive loss rules do not apply to working interests in oil and gas property if the taxpayer's liability for the activity is not limited.  IRC Sec. 469(c)(3). The owner of a working interest has responsibility for authorizing expenditures. Additionally, the owner usually has voting rights in proportion to his investment and has the right to continue operations if the present operator decides to stop. Finally, the owner of a working interest bears a proportional interest of tort liability (e.g., if a well explodes and injures somebody) and is responsible for sharing in further costs if a decision is made to spend more money than has already been invested. As mentioned above, a working interest in oil and gas property is exempt from the passive loss rules only if the investor's liability is not limited. This means that oil and gas limited partnerships will not be exempt because the liability is limited to the amount invested.

Exceptions Relating to Rental Real Estate

The rule which automatically classifies rental activity as a passive activity is not applicable to taxpayers whose primary activity is in the real estate business (according to standards set forth in Code Section 469(c)(7)).

In addition, taxpayers not considered to be in the real estate business may deduct up to $25,000 in losses from rental real estate against other income if the taxpayer actively participates in the rental real estate activity.  IRC Sec. 469(i). Less involvement is required for active participation under this rule than for the material participation required for the deduction of trade or business losses generally under Sections 469(c)(1) and 469(h). Active participation need not entail direct involvement in operations. For example, an owner may hire another person to manage rental property as long as the owner retains a voice in management decisions, such as amount of rent, major repairs and lease terms. The deduction allowable under this exception is phased out when adjusted gross income (determined without regard to passive losses) begins to exceed $100,000, with full phase-out when AGI reaches $150,000.

Partial Exception for Rehabilitation and Low-Income Housing Credits

Rehabilitation and low-income housing credits may be used to offset tax on up to $25,000 of nonpassive income regardless whether the taxpayer actively participates.  IRC Sec. 469(i)(6)(B). This exception is phased out between adjusted gross incomes of $200,000 and $250,000.  IRC Sec. 469(i)(3)(B).

Income Tax Planning Techniques

The At Risk Provisions

In the past, investors were able to use nonrecourse financing to generate tax loss deductions in excess of their actual investments. With nonrecourse financing, the lender may proceed only against the underlying collateral in the event of default. Congress has limited the attractiveness of many tax shelters by limiting most loss deductions and investment tax credits to the amount an investor has at risk, i.e., the amount he could actually lose in the transaction.  IRC Secs. 49 and 465. Registration of Tax Shelters

Any organizer of a tax shelter (the person principally responsible for its organization) is required to register the shelter with the IRS if the investment form meets the following tests:

* The offering materials or representations made to a prospective investor claim to provide a greater than 2 to 1 write-off in any of the first five years of the investment;
* The investment is either: (i) required to be registered under a federal or state law regulating securities, (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating offer or sale of securities (for example, under Regulation D of the SEC or Section 4(2) of the Securities Act of 1933); or (3)The aggregate amount to be offered for sale exceeds $250,000, and there are expected to be five or more investors.

Upon registration, the tax shelter is assigned a tax shelter identification number which must be provided to each investor, and investors are required to include such number when reporting losses in their individual returns.

IRC Section 6707 imposes penalties for failure to register, late registration, providing false or incomplete information, and failure to provide an investor with the tax-shelter identification number.

Life Insurance: The Ultimate Shelter

Life insurance offers perhaps the ultimate tax shelter. It produces no current income, yet when the death benefit is received, none of it is taxable to the beneficiary.  IRC Sec. 101(a)(1). There is no tax on the inside buildup of cash values. Therefore, policies with competitive rates of return can offer compounded growth that will exceed the after-tax growth of currently taxable investments. This makes life insurance a highly attractive investment for retirement planning and for building educational funds.

Income Tax Planning Techniques

Insurance Commissions

In general, the first-year and renewal commissions of an agent are a part of gross income. Gratuitous assignment by the agent of the right to renewal commissions will avoid taxation of these renewals to the agent. If the commissions are sold by the agent, they will be taxed to the purchaser, to the extent they exceed the purchase price. After the agent's death, the renewal commissions will be taxed as income in respect of a decedent to the recipient.

Obviously, first-year and renewal commissions are a part of an agent's gross income for federal income tax purposes. The agent must even include commissions on policies which he or she buys on his or her own or another's life.  *Ostheimer v. U.S*., 264 F.2d 789 (3rd Cir. 1959); Rev. Rul. 55-273, 1955-1 C.B. 221. This rule also applies to a broker.  *Comm  v. Minzer*, 279 F.2d 338 (5th Cir. 1960); *Bailey v. Comm*., 41 T.C. 663 (1964).

When an agent sold life insurance to his friends, and waived the commissions payable thereon, the waived commissions were nonetheless reportable as income.  *Mensik v. Comm.*, 328 F.2d 147 (7th Cir. 1964), aff'g 37 T.C. 703 (1962).

Advance on Commissions

A beginning agent in the insurance business must be financed by the company for a period of time unless he has a remarkable aptitude for the business. This company financing may take the form of advances on future commissions which the company anticipates the new agent will earn. The question arises as to whether these advances are taxable income when received.

The tax result depends upon the specific arrangement between the company and the agent. If the advances are not required to be repaid even if the agent fails to generate commissions in an amount equal to the advances, then the advances are income when received*.  George Blood Enterprises, Inc. v. Comm.,* T.C. Memo 1976-102; see also Rev. Rul. 83-12, 1983-1 C.B. 99, and cases cited therein. Even under an arrangement where agents may eventually be required to repay advances in excess of commissions ultimately earned, the advances may not be treated as nontaxable loans. In a 1995 TAM the IRS took the position, on the particular facts presented, that the advances lacked indicia of loans since they were not represented by promissory notes and bore no interest. With regard to the repayment requirement, the IRS viewed it as at most a "contingent liability."