Tax Planning for Millionaires

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Learning Objectives

1. Describe how the IRS is targeting millionaires with its new Global High Wealth Industry Group
2. Explain why millionaires should accelerate most itemized deductions into tax year 2010
3. Explain why millionaires should use more exclusions and above-the-line deductions, especially for tax year 2011 and later

Learning Objectives

4. Explain how millionaires can minimize taxes on retirement plans, including converting a retirement plan account or traditional IRA to a Roth IRA
5. Explain strategies millionaires should consider about the recognition of net capital gains and net capital losses
6. Explain how millionaires can use investments in oil and gas drilling partnerships to reduce their income tax
Learning Objectives

7. Explain how millionaires can use real estate to save taxes
8. Illustrate how to provide tax planning advice to millionaires using a fictitious case scenario

Learning Objective 1

Describe how the IRS is targeting millionaires with its new Global High Wealth Industry Group
Taxing Millionaires

- Who wants to tax a millionaire? The IRS—that’s who
- The IRS launched the Global High Wealth Industry Group in late 2009
- It is housed in the large and mid-size business operating division

Goal of Global High Wealth Industry Group

- Goal is to centralize and focus IRS compliance expertise on millionaires and their related entities
Initial Focus

The initial focus of the Global High Wealth Industry Group is on individuals with over $10 million in income or assets.

On the IRS Radar

• Trusts
• Real estate investments
• Royalty and licensing agreements
• Revenue or equity sharing arrangements
On the IRS Radar

- Private foundations
- Privately held corporations
- Flow through entities
- Celebrities
- Professional athletes
- Expatriates

CPAs to the Rescue

- Millionaires look to CPAs to rescue them from high taxes and an increasingly aggressive IRS
- CPAs can help millionaires reduce their taxes and protect them from new taxes
Learning Objective 2

Explain why millionaires should accelerate most itemized deductions into tax year 2010

Itemized Deductions

- Most itemized deductions have been phased out based on AGI (Sec. 68)
- Deductions for medical expenses, investment interest, and casualty and theft losses are not subject to the phaseout (Sec. 68(c))
- The amount of the phaseout has itself been phased out the last few years
Phaseout Rule for 2010 and 2011

• The phaseout rule does not apply for tax year 2010
• Thus, itemized deductions are allowed in full for tax year 2010
• The phaseout rule returns for tax year 2011

Tax Savings Strategy for 2010

• Accelerate itemized deductions into tax year 2010
  – Make mortgage payments due on January 1, 2011, in 2010 (a taxpayer may not deduct mortgage payments due on February 1, 2011, and later in 2010 (Sec. 461(g)(1)))
  – Make charitable contributions in 2010
  – Make payments for real estate taxes in 2010
Tax Savings Strategy for 2011

• In 2011 and later years, consider electing to capitalize mortgage interest and real estate taxes on any raw land held for investment (Sec. 266 and Reg. § 1.266-1)
• Avoids losing itemized deductions due to phaseout
• Decreases gain or increases loss on future sale of the property

Learning Objective 3

Explain why millionaires should use more exclusions and above-the-line deductions, especially for tax year 2011 and later
Exclusions and Above-the-Line Deductions

• Itemized deductions will be of lesser value in 2011 to millionaires who have a large AGI because of the phaseout rule of Sec. 68
• Focus more on exclusions and above-the-line deductions for income tax savings opportunities
• Works best for taxpayers whose AGI is not very high above the applicable amount for the phaseout rule of Sec. 68

Emphasize Exclusions and Above-the-Line Deductions

• Gain on sale of certain small business stock (Sec. 1202)
• Health reimbursement accounts (Sec. 105)
• Cafeteria plans (Sec. 125)
• Health savings accounts (Sec. 223)
• Municipal bond interest (Sec. 103)
• Gain on sale of home (Sec. 121)
Emphasize Exclusions and Above-the-Line Deductions

- Reimbursements for employee business expenses under an accountable plan (Reg. § 1.62-2)
- Certain fringe benefits (Sec. 132)
- Section 179 deduction for eligible property purchased and placed in service in a trade or business
- Start-up costs (Sec. 195)

Exclusion of Gain on Sale of Qualified Small Business Stock

- The Small Business Jobs Act of 2010 amends Sec. 1202 to provide for a 100 percent exclusion of the gain on qualified small business stock acquired after September 27, 2010, and before January 1, 2011, and held for more than five years (Sec. 1202(a)(4))
- The usual exclusion is 50 percent, but it is 75 percent for qualified stock acquired in 2009 and on or before September 27, 2010 (Sec. 1202(a)(3))
Alternative Minimum Tax Preference

The Small Business Jobs Act of 2010 repealed the alternative minimum tax preference under Sec. 57(a)(7) for the excluded gain on the sale of qualified small business stock acquired after September 27, 2010, and before January 1, 2011, and held for more than five years (Sec. 1202(a)(4))

Qualified Small Business Stock

- Must be stock in a C corporation acquired as original issue stock either directly from the corporation or from an underwriter
- Must be acquired in exchange for property other than other stock or as compensation for services
- Must meet active business requirement or be a specialized small business investment company (Sec. 1202(c))
- Gross assets may not exceed $50,000,000 (Sec. 1202(d))
Health Reimbursement Accounts

- The employer may pay for the employee's medical expenses
- HRAs that meet all the requirements provide tax-free reimbursements to the employee and a tax deduction to the employer (Secs. 105 and 162(a))

Section 125 Plans

- Great way to shelter the medical expenses of employees without having to spend over 7.5 percent of AGI
- Reimbursements for more expenses excludable under Sec. 125 than are deductible as medical expenses under Sec. 213
- Saves income taxes and Social Security/Medicare taxes
Change in Section 125 Plans Beginning in 2011

- May not use a debit card tied to a Section 125 plan to purchase over-the-counter products
- Under the Patient Protection and Affordable Care Act, such products require a prescription and a claim form for reimbursement (Secs. 106(f) and 125(f))
- Insulin requires no prescription, but the taxpayer must file a claim form (Secs. 106(f) and 125(f))
- Small employers may offer a “simple” cafeteria plan (Sec. 125(j))

Health Insurance Deduction for the Self-Employed

The Small Business Jobs Act of 2010 allows a self-employed individual to deduct the cost of health insurance for the owner and the owner’s family in calculating the self-employment tax for tax year 2010 only (Sec. 162(l)(4))
Start-Up Costs

- The Small Business Jobs Act of 2010 amends Sec. 195 to allow a new business to deduct start-up costs incurred in 2010 only up to $10,000 instead of the usual limit of $5,000.
- Excess still amortized over 15 years (Sec. 195(b)(1))
- The immediate deduction begins to phase out for start-up costs over $60,000 for start-up costs incurred in 2010 only instead of the usual threshold of $50,000 (Sec. 195(b)(1))

Section 179 Deduction for 2010 and 2011

- Maximum deduction increased to $500,000 in 2010 and in 2011 by the Small Business Jobs Act of 2010 (Sec. 179(b)(1)(B)).
- Maximum amount is phased out for $1 for each $1 that eligible purchases exceed $2,000,000 in 2010 and 2011 as increased by the Small Business Jobs Act of 2010 (Sec. 179(b)(2)(B)).
- Saves income tax and saves self-employment tax for self-employed individuals (Sec. 1402(a))
- Any gain on later sale is excluded from self-employment income (Sec. 1402(a)(3)(C))
Eligible Property for the Sec. 179 Deduction

Tangible, depreciable property and off-the-shelf computer software acquired by purchase and placed in service in a trade or business (Sec. 179(d)(1))

Certain Other Property Eligible for Limited Sec. 179 Deduction

The Small Business Jobs Act of 2010 allows a taxpayer to deduct under Sec. 179 up to $250,000 of certain real estate, qualified leasehold improvements, qualified restaurant property and qualified retail improvement property as defined in Secs. 168(e)(6), 168(e)(7) and 168(e)(8) (Sec. 179(f))
Unused Sec. 179 Deduction for Certain Other Property

- Taxpayer may not carry over unused Sec. 179 deduction for certain other property to 2012 and later years
- Taxpayer treats it as a separate property deemed to have been placed in service on January 1, 2011, which is subject to depreciation (Sec. 179(f)(4))

Section 179 Deduction for Pickup Trucks and SUVs

- Available for pickup trucks with a gross vehicle weight of over 6,000 pounds with no special limit (Sec. 280F(d)(5))
- SUVs with a gross vehicle weight of over 6,000 pounds but fewer than 14,000 pounds are generally limited to $25,000 (Sec. 179(b)(5))
Net Income Limit on the Section 179 Deduction

- Deduction limited to the net income from any trade or business before the Sec. 179 deduction (Sec. 179(b)(3))
- Wages and salaries count as business income for this purpose, which can help employees who want to start a new business (Reg. § 1.179-2(c)(6)(iv))

Bonus Depreciation

50 percent bonus depreciation is allowed on depreciable personal property and placed in service before January 1, 2011, or if certain long-lived property before January 1, 2012, as extended by the Small Business Jobs Act of 2010 (Sec. 168(k)(2)(A))
Bonus Depreciation on Automobiles

- Under the Small Business Jobs Act of 2010, bonus depreciation up to $8,000 is allowed on “luxury” automobiles purchased and placed in service in a trade or business in 2010 (Sec. 168(k)(2)(F))
- Total allowed depreciation for each automobile purchased and placed in service in a trade or business is $11,060 ($8,000 + $3,060)

Learning Objective 4

Explain how millionaires can minimize taxes on retirement plans, including converting a retirement plan account or traditional IRA to a Roth IRA
Convert Retirement Plan Accounts and IRAs to Roth IRAs

- No income limit on conversions of retirement plan accounts and/or IRAs to Roth IRAs in 2010 and later years (Sec. 408A(c)(3))
- Do not have to convert all retirement plan accounts and/or IRAs in the same year
- Income limits still apply for contributions
- Married filing separately may convert retirement plan accounts and/or IRA to Roth IRA in 2010 and later years (Sec. 408A(c)(3))

What Kinds of IRAs May a Taxpayer Convert to a Roth IRA?

- Traditional IRAs
- Nondeductible IRAs
- Rollover IRAs
- SEP-IRAs
- SAR-SEP IRAs
- SIMPLE IRAs (contributions to SIMPLE IRAs cannot be converted until after two years) (Sec. 72(t)(6))
401k, 403b, and 457 Plans

- Taxpayers may convert amounts in a 401k plan, 403b plan, or 457 plan if the plans have a designated Roth account option and the balances are eligible for distribution and rollover, such as for individuals who have separated from service.
- If the requirements are met, a rollover to a traditional IRA is not required.
- Taxpayer may convert the balances eligible for a distribution or rollover in a 401k plan, 403b plan, or a 457 plan directly to a Roth IRA (Sec. 402A(c)(4)).

Immediate Conversions

- A taxpayer may contribute to a nondeductible IRA.
- Then, immediately convert the nondeductible IRA to a Roth IRA.
- A taxpayer whose income is too high to contribute to a Roth IRA may repeat this process every year.
Combine All IRAs to Calculate Tax on Conversion

- Taxpayers would incur a tax liability if they convert a nondeductible IRA to a Roth IRA if they have any tax-deferred IRAs
- Sec. 408(d)(2) treats all IRAs as one for purposes of calculating the gross income recognized on a distribution under Sec. 72, including a conversion to a Roth IRA

Recognizing Income on a Conversion to a Roth IRA

- Income on conversions in 2010 generally recognized 50 percent in 2011 and 50 percent in 2012 (Sec.408A(d)(3))
- A taxpayer may elect to recognize all of the income on the conversion in 2010 (Sec. 408A(d)(3))
- The 10 percent additional tax under Sec. 72(t) does not apply (Sec. 408A(d)(3)(A)(iii))
Factors to Consider

- Tax rates in 2010 and expected tax rates in 2011 and later years
- Effect of increase in AGI on taxation of any Social Security benefits
- Effect of increase in AGI on itemized deductions and credits
- The time value of money

Recharacterizing a Roth IRA after Conversion

- A taxpayer has until the due date of the tax return, including extensions, to reverse the conversion from an IRA to a Roth IRA (Sec 408(d)(4))
- Distribution returned must include any earnings (Reg. § 1.408A-5)
- Do not place amount converted to a Roth IRA in an existing Roth IRA
- Use a separate Roth IRA for the conversion
Tax-Free Distributions from Roth IRAs

Income from a Roth IRA distribution is excluded from gross income if
- The taxpayer is at least age 59 ½, disabled, or has died (Sec. 408A(d)(2)(A)) and
- The Roth IRA was deemed to have begun at least five years before the distribution (Sec. 408A(d)(2)(B))

When Five-Year Period Begins for Contributions

- The five-year period begins at the beginning of the tax year for which the first Roth IRA contribution is attributable or if earlier, the first day of the tax year of any conversion contribution to any Roth IRA (Reg. § 1.408-6 Q&A 2)
- For example, the first contribution to a Roth IRA occurred on April 15, 2011, and was attributed to tax year 2010. The five-year period begins on January 1, 2010
When Five-Year Period Begins for Conversions

• For purposes of Sec. 72(t), the five-year period begins for EACH conversion at the beginning of the calendar year in which the conversion to a Roth IRA occurred (Reg. § 1.408A-6 Q&A 5)
• For example, a conversion from a traditional IRA to a Roth IRA occurred on March 15, 2010. The five-year period begins on January 1, 2010
• This five-year period may differ from the five-year period used to determine if a distribution is a qualified distribution
• See IRS Publication 690, “Individual Retirement Arrangements (IRAs) ”

Minimum Distribution Requirements

• Taxpayers with traditional IRAs are subject to a minimum distribution requirement beginning on April 1 after the year the taxpayer reaches age 70 ½ (Secs. 401(a)(9) and 408(a)(6))
• Roth IRAs are not subject to the minimum distribution requirement before the death of the taxpayer (Sec. 408A(c)(5))
Tax Issues for IRAs at Death

• Regular IRAs, retirement plan accounts, and Roth IRAs are subject to estate tax (except for decedents who die in 2010) (Sec. 2031)
• Regular IRAs and tax-deferred retirement plan accounts are subject to income tax as income in respect of a decedent (Sec. 691(a))
• Roth IRAs are not subject to income tax as income in respect of a decedent unless the taxpayer dies before meeting the five-year requirement

Tax Savings Strategy

• Convert tax-deferred retirement plan accounts and traditional IRAs to life annuities
• Use other tax planning techniques to reduce the additional income tax from the annuities
Tax Savings Strategy

- If the taxpayer is insurable, form an irrevocable life insurance trust with a Crummey powers clause
- The taxpayer gives money to the trust and it qualifies for the annual gift tax exclusion
- The trust buys life insurance on the taxpayer
- Upon the taxpayer's death, the beneficiaries receive the life insurance proceeds free of income tax (Sec. 101) and free of estate tax (Sec. 2042)

Another Possible Strategy

- Bequeath tax deferred pension plan accounts and tax-deferred IRAs to a tax-exempt charity
- Avoids income tax for income in respect of a decedent
- Reduces the taxable estate and thereby reduces the estate tax (Sec. 2055)
Effect on Gross Estate

- Payment of income taxes on a conversion of a retirement plan account or a traditional IRA to a Roth IRA or on a conversion of a tax-deferred retirement plan account or traditional IRA to an annuity removes assets from the gross estate and thereby reduces the estate tax.
- Also generally prevents any later income tax on income in respect of a decedent.

Learning Objective 5

Explain strategies millionaires should consider about the recognition of net capital gains and net capital losses.
Long-Term Capital Gains

- A net capital gain (excess of net long-term capital gain over any net short-term capital loss) for the most common investments is taxed at a maximum rate of 15 percent in 2010 (Sec. 1(h)(1)(C))
- A rate of 25 percent applies to depreciation recapture on depreciable real estate (Sec. 1(h)(1)(D))
- A rate of 28 percent applies to collectibles (Sec. 1(h)(4))

Increase in Tax Rate on Net Capital Gains

The tax rate on most net capital gains and qualified dividends increases from 15 percent to 20 percent in 2011
Tax Savings Strategy

• Sell investments that would generate long-term capital gains in 2010
• Compare higher tax rate in 2011 with time value of money

Wash Sale Rules
Do Not Apply to Gains

• Taxpayers can sell capital assets to realize a long-term capital gain in 2010 and repurchase the capital assets if they so desire
• The wash sale rules of Sec. 1091 apply to losses but not to gains
Limited Deduction for Net Capital Losses

- An individual or married couple may deduct a maximum of $3,000 a year ($1,500 on a married separate return) of a net capital loss (Sec. 1211(b))
- Remaining loss carried forward indefinitely (Sec. 1212(b)(1))
- Millionaires must be very careful when investing in capital assets such as common stocks

Tax Savings Strategy

- Qualify investments in the taxpayer’s own business under Sec. 1244 in case the taxpayer must later sell the stock at a loss
- Up to $50,000 a year (up to $100,000 a year on a joint return) of the loss on the sale of Sec. 1244 stock that year is deductible as an ordinary loss
- Invest directly in business assets so that if a loss results, the loss will be an ordinary loss or a Sec. 1231 loss
Learning Objective 6

Explain how millionaires can use investments in oil and gas drilling partnerships to reduce their income tax.

Oil and Gas Working Interests

- Not a passive activity if the taxpayer owns it directly or through an entity (Sec. 469(c)(3)(A))
- The taxpayer does not have to materially participate in the activity (Sec. 469(c)(4))
Oil and Gas Working Interests

• The entity must not limit the taxpayer’s liability (Sec. 469(c)(3)(A))
• Thus, the taxpayer cannot be a limited partner, an S corporation shareholder, or an LLC member
• The taxpayer must be a sole proprietor or a general partner

Deduction for Intangible Drilling and Development Cost

• One of the main benefits is that the taxpayer may elect to deduct intangible drilling and development cost rather than capitalizing such costs (Sec. 263(c))
• Such costs may exceed 80 percent of the taxpayer’s initial investment
Self-Employment Tax Issues

• A general partner is subject to self-employment tax on guaranteed payments for services and on the partner’s distributive share of the partnership’s ordinary income (Sec. 1402(a))
• A limited partner is subject to self-employment tax only on guaranteed payments for services (Sec. 1402(a)(13))
• A partnership may allow a partner to convert from a general partner to a limited partner in a later year

Depletion Deduction

• Once production begins, a taxpayer who is an independent producer or royalty owner may claim the greater of 15 percent statutory depletion or cost depletion (Sec. 613A(c)(1))
• Usually, the taxpayer will claim statutory (percentage) depletion
• The depletion deduction may not exceed 65 percent of the modified taxable income for the year (Sec. 613A(d))
Percentage Depletion Deduction and Adjusted Basis

- Cost depletion may not exceed the taxpayer’s adjusted basis in the property (Sec. 612)
- A taxpayer may claim percentage depletion even if total depletion would exceed the adjusted basis in the property
- Adjusted basis cannot be negative

Tax Savings Strategy

- Change to limited partner when the activity becomes profitable if the partnership allows
- Avoid self-employment tax on the income from the oil and gas working interest
- Limits the taxpayer’s liability for causes of action that occur after the taxpayer changes to a limited partner
Future Income After Loss

- If a taxpayer treats a loss from an oil and gas working interest as a nonpassive loss
- Future income from such interest is treated as nonpassive income (Sec. 469(b)(3)(B))

Net Operating Loss Carryback

- Taxpayer can invest in oil and gas working interests two years after receiving large amount of income
- Loss from intangible drilling costs and depreciation deductions offsets income in year of investment
- Carries any net operating loss (NOL) back two years on Form 1045 to obtain refund of taxes paid two years earlier (Sec. 172(b)(1)(A))
Example of a Large Increase in Income Two Years Ago

• Lucky won $5,000,000 lump sum in the state lottery in 2008
• Lucky paid over $1,700,000 in federal income tax in 2008
• He kept most of the winnings he had left in the bank

Loss from Oil and Gas Partnership

• In 2010, Lucky invests $3,000,000 as a general partner in a partnership that owns working interests in oil and gas properties
• Lucky’s loss from the partnership due to intangible drilling costs and depreciation is $2,700,000 for 2010
NOL Carryback

- He receives a refund of all federal income taxes withheld for 2010
- Lucky carries the NOL back to 2008 and applies for a tentative refund using Form 1045
- He receives a significant refund of the taxes he paid in 2008

Learning Objective 7

Explain how millionaires can use real estate to save taxes
Low Income Housing Credit

- Sec. 42 allows a refundable credit for a period of 10-11 years for investments in certain low income housing
- May generate passive losses that are usually not deductible until the property is sold
- Complex, long-term investment
- Some companies specialize in such investments
- The economic viability of such investments can change as the real estate market changes

Real Estate Exceptions to the Passive Activity Loss Rules

- Limited deductibility of losses from real estate for properties in which an individual actively participates (Sec. 469(i))
- Real estate losses for a qualified real estate professional (Sec. 469(c)(7))
Active Participation Exception

- Passive activity losses allowed up to $25,000 (Sec. 469(i)(2)) (up to $12,500 for married filing separately (Sec. 469(i)(5)(A)(i))
- Phased out by $1 for each $2 that modified AGI exceeds $100,000 (Sec. 469(i)(3)(A)) ($50,000 for married separate (Sec. 469(i)(5)(A)(ii))

Not That Helpful to Millionaires

- The active participation exception is usually not that beneficial to millionaires
- Their high AGI causes the allowable deductible loss to be phased out
Real Estate Professional

More than half of the personal services performed in trades or businesses must be performed in real property trades or businesses in which the taxpayer materially participated (Sec. 469(c)(7)(B)(i))

Real Estate Professional

In addition, the taxpayer must have performed more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participated (Sec. 469(c)(7)(B)(ii))
Joint Return

On a joint return, at least one spouse must separately meet the requirements (Sec. 469(c)(7)(B))

Real Property Businesses

- Development
- Redevelopment
- Construction
- Reconstruction
- Acquisition
- Conversion
- Rental
  (Continued)
Real Property Businesses

- Operation
- Management
- Leasing
- Brokerage
- (Sec. 469(c)(7)(C))

Does Real Estate Agent Qualify?

In Agarwal v. Commissioner, TC Summary Opinion 2009-29 (March 2, 2009), the U. S. Tax Court held that a real estate agent who works under a real estate broker may qualify as a real estate professional under Sec. 469(c)(7)
No Limit to Deductibility of Losses from Real Estate

If the taxpayer is a real estate professional, all passive losses from real estate are allowed in full (Sec. 469(c)(7)(A)(i))

Election Regarding Activities

• If the taxpayer is a qualified real estate professional, the default rule is that the taxpayer’s interest in each in rental real estate is a separate activity
• The taxpayer may elect to treat all interests in rental real estate as one activity (Sec. 469(c)(7)(A))
Learning Objective 8

Illustrate how to provide tax planning advice to millionaires using a fictitious case scenario

Case Scenario: Joe and Mary

- Joe, age 45, and Mary, age 42, are married and file a joint return. They live in Orlando and have two children: Sam who is 14 and Sara who is 12.
- They come to you for tax planning advice in November 2010
Joe’s Business

• Joe is self-employed. He operates his business as an LLC
• He is the sole member of the LLC
• It is taxed as a disregarded entity
• His net income from the business is about $400,000 a year

Mary’s Employment

• Mary is employed as a marketing manager of a consumer products company.
• She receives a salary of $96,000
Mary Considers Job in Real Estate

- Mary has grown tired of her job
- She has always had an interest in real estate
- She believes that the real estate market is about to get better
- She is thinking about becoming a real estate agent

Joe and Mary’s Real Estate Investments

- Joe and Mary own two small apartment complexes
- They have a passive activity loss carryforward of $80,000 from these apartment buildings
- Their large amount of AGI has caused the allowable loss deduction to be phased out completely
Joe and Mary’s Cash and Common Stocks

- Joe and Mary have $2 million in certificates of deposit and bank accounts
- ABC:
  - FMV $600,000
  - Basis $150,000
  - Unrealized Gain $450,000
- DEF:
  - FMV $180,000
  - Basis $260,000
  - Unrealized Loss ($80,000)

Joe and Mary’s Home

- Joe and Mary own their own home as tenants by the entirety
- It has a fair market value of $1,000,000
- They bought it in 1997 for $800,000
Joe and Mary’s Mortgage

- They owe $680,000 on a mortgage loan at a fixed interest rate of 6.5 percent.
- The monthly mortgage payment is due on the first of each month.
- They have paid the mortgage payment that was due on December 1, 2010, but they have not paid the mortgage payment that is due on January 1, 2011.

Joe and Mary’s Retirement Plans

- Joe has $442,000 in a tax deferred SEP-IRA through his business
- Mary has $225,000 in a tax-deferred 401k plan from a previous employer
- They have their retirement accounts invested in a diversified portfolio of mutual funds
Joe and Mary’s Education Plan

- Joe and Mary expect their children Sam and Sara to attend private colleges.
- Joe and Mary have no tax advantaged education plan for their children.

Joe’s Life Insurance

- Joe has a term life insurance policy with death benefit of $1,000,000
- Joe is the owner of the policy
- Mary would receive $600,000 of the proceeds
- The remaining $400,000 would go into a testamentary trust for the benefit of the children
Charitable Contributions

• Joe and Mary usually give about $5,000 in cash each month to the First Community Church, where they are active members
• Mary gives about $300 in cash each month to a local charity called Helpers, which provides food and shelter to the needy

How Do You Advise Them?

• Home
• Charitable contributions
• Business issues
• Real estate investments
• Common stocks
• Retirement plan
• Life insurance
• Education plan
• Investments in oil and gas drilling partnerships
Home

- They could pay the mortgage off
- Possibly they could refinance the home mortgage at a lower interest rate
- They could also consider selling their home to realize a tax-free gain under Sec. 121 and buy another home, which they could likely finance at a lower interest rate

Home Mortgage

- Pay the mortgage payment that is due on January 1, 2011, in December 2010
- Itemized deductions in 2010 are not subject to the phaseout rule
- Itemized deductions in 2011 are subject to the phaseout rule
Charitable Contributions

- As much as possible, accelerate charitable contributions into 2010
- Itemized deductions in 2010 are not subject to the phaseout rule
- Itemized deductions in 2011 are subject to the phaseout rule

Business Issues

- If LLC remains taxed as a disregarded entity, consider hiring the children to work in the business
- Wages would not be subject to FICA taxes (Sec. 3121(b)(3)(A)) until the child reaches age 18
Business Issues

• Consider purchasing any needed equipment and placing it in service in 2010 to take advantage of the increase in the Sec. 179 deduction and the extension of bonus depreciation
• Consider making the election to have the LLC taxed as an S corporation to save payroll taxes

Real Estate Investments

• If Mary becomes a real estate agent, she would be a qualified real estate professional
• Losses from their real estate investments would no longer be subject to the passive activity loss rules
Common Stocks

- Consider selling ABC to realize the unrealized gain of $450,000
- Advantage: pay tax at rate of only 15%
- Disadvantage: must pay tax now

Retirement Plan

- If Mary quits her job, she should consider transferring the money in her 401k plan to a Roth IRA
- She may pay include 50 percent of the income from the conversion in 2011 and 2012
- She may elect to include all of the income from the conversion in 2010
Life Insurance

• Consider transferring the life insurance policy to an irrevocable life insurance trust
• He would have to live for three years to keep the life insurance proceeds out of his gross estate (Secs. 2035 and 2042)
• If insurable, cancel the policy, form an irrevocable life insurance trust with a Crummey powers clause, and have the trust buy a new policy. He would keep the life insurance proceeds out of his gross estate.

Education Plan

• Consider placing money into a Section 529 plan
• Can give up to five times the annual gift tax exclusion amount, which is $13,000 for 2010, without incurring a gift tax or using any of the $1,000,000 lifetime exemption (Secs. 529(c)(2) and 2503(b))
• So, they could place $130,000 ($13,000 x 2 x 5) into a Sec. 529 plan for their children
Oil and Gas Drilling Partnerships

- Consider investing part of their money in oil and gas drilling partnerships for its tax benefits and potential high returns
- Investment should cover many wells with a company with a good track record
- Due diligence is essential

Summary

- Millionaires usually benefit little from itemized deductions, but 2010 is different
- Focus on exclusions and above-the-line deductions, especially for tax year 2011 and later
- Consider investments that qualify for the Sec. 42 low income housing credit
Summary

• Investing in oil and gas drilling partnerships as a general partner can provide significant tax savings
• With the NOL provisions, a taxpayer has two years to invest in oil and gas drilling partnerships to reduce taxes paid two years ago
• If the taxpayer or the taxpayer's spouse is a real estate professional, losses from real estate investments are deductible in full

Conclusion

• By providing good tax planning services to millionaires, you can
  – Save them taxes
  – Grow your own practice
  – Increase your own net worth and possibly become a millionaire
Appendices

1. Grouping Activities
2. Proving Material Participation and Losses
3. Seven Ways to Materially Participate
4. Significant Participation Activity
5. Personal Service Activities

Appendix 1

Grouping Activities
Grouping Activities

- A taxpayer may group business activities into one activity if the activities are suitable for being combined for measuring gain or loss under Sec. 469 (Reg. §1.469-4(c)(1)) based on all facts and circumstances.
- In general, a taxpayer may not group a rental activity with a business activity (Reg. §1.469-4(d)(1)).

Regrouping Activities

The IRS may regroup a taxpayer’s activities to prevent tax avoidance (Reg. §1.469-4(f)).
Disclosure About Groupings

• Rev. Proc. 2010-13 (IRB 2010-4) requires taxpayers to disclose passive activity groupings and regroupings on their income tax returns
• Disclosure not required if the taxpayer disposes of an activity within a grouping

When Disclosures Required to Begin

• Groupings made before tax years beginning on January 25, 2010, are required only if the taxpayer adds new activities to existing groupings or regroupings
• Calendar year taxpayers do not have to disclose original groupings until they file their returns for tax year 2011 in 2012
What Taxpayers Must Disclose

- Names
- Addresses
- Employer ID numbers
- For all activities being grouped
- New activities added to existing groups
- Regroupings of original groupings

When Regroupings Required

- Regroupings of original groupings are required when the original groupings are clearly inappropriate
- The taxpayer must state on the disclosure that the regrouped activities are an appropriate economic unit and explain why the original grouping was inappropriate or is now inappropriate
- Reg. § 1.469-4 still applies
Special Rules for Partnerships and S Corporations

- The partnership or S corporation must disclose the groupings to the partners or shareholders
- The partnership or S corporation must disclose to each partner or shareholder the income or loss from each grouping on an attaching to the Schedules K-1

Partners and Shareholders May Not Treat as Separate Activities

Partners and S corporation shareholders may not treat activities as separate activities if the partnership or S corporation placed them into a group
Consequences for Noncompliance

• If the taxpayer fails to comply with the disclosure rules, the IRS will usually treat each activity as a separate activity
• The IRS may group activities to prevent tax avoidance

Appendix 2

Proving Material Participation and Losses
Tax Court Rules on LLCs and LLPs

The U. S. Tax Court held in *Paul D. Garnett and Alicia Garnett v. Commissioner*, 132 TC No. 19 (June 30, 2009) that an interest in an LLC or LLP, in which the taxpayer was not a limited partner, is not per se passive under Sec. 469(h)(2).

Limited Liability Not Conclusive

The fact that the taxpayers had limited liability did not preclude them under state law from materially participating in the activities of the LLCs and LLPs.
U. S. Court of Federal Claims
Renders Similar Decision

The U. S. Court of Federal Claims held in James R. Thompson v. United States of America, 2009-2 USTC ¶50,501 (July 20, 2009) that an interest in an LLC was not a limited partnership interest for purposes of the passive activity loss rules.

- The Court cited the U. S. Tax Court’s ruling in Garnett.

Material Participation Not Proven

In Loren A Dean v. Internal Revenue Service, 2009-1 USTC ¶50,185 (September 2, 2008) (an unpublished opinion), aff’g WD Washington, 2007-2 USTC ¶50,845 (February 7, 2007) the U. S Court of Appeals for the Ninth Circuit, held that the taxpayer did not meet his burden of proving that he materially participated in an activity.
Tax Savings Strategy

• Keep a log of hours worked in an activity to prove material participation
• If possible, have an independent third party who witnessed the activity to sign the log to attest to its accuracy

Worthless Stock

In *Alan Bilthouse and Patricia Bilthouse v. United States of America*, 2009-1 USTC ¶ 50,158 (January 15, 2009), aff’g ND Illinois, 2007-2 USTC ¶50,680 (September 28, 2007) the U. S Court of Appeals did not allow the taxpayers to claim their suspended passive activity losses from an S corporation
Taxpayer Did Not Prove the Year the Stock Became Worthless

The evidence indicated that the stock in the S corporation became worthless two years before the taxpayers claimed it became worthless.

Tax Savings Strategy

If the evidence is not clear when a stock becomes worthless, consider filing a protective refund claim for each year in which it might be found to have become worthless, especially if the loss is magnified by suspended passive activity losses.
Closing Agreement Regarding Amount at Risk

In *Lyman F. Bush, et al. v. United States of America*, 2008-2 USTC ¶50,574 (September 23, 2008), the U. S Court of Federal Claims held that a closing agreement regarding suspended losses under the amount at risk rules of Sec. 465 did not constitute a waiver of the passive activity loss rules of Sec. 469.

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Tax Savings Strategy

• If the taxpayer has suspended passive activity losses or expects losses from passive activities in the current year, then
  • Invest in passive activities likely to generate passive net income (passive income generator (PIG))
Appendix 3

Disposing of Passive Activities

Taxable Disposition of the Activity

- Deduct suspended passive activity losses upon a complete disposition of the activity in a fully taxable transaction (Sec. 469(g)(1)(A))
- The disposition must not be to a related party (Sec. 469(g)(1)(B))
Disposition by Gift

- If the taxpayer disposes of an interest in an activity with a passive activity loss carryforward, then
- Neither the donor nor the donee may ever deduct the suspended passive activity losses
- Rather, the suspended passive activity losses increase the basis of the property to the donee (Sec. 469(j)(6))

Tax Savings Strategy

- Do not dispose of activities with suspended passive activity losses by gift
- Sell the interest in the passive activity in a taxable transaction to an unrelated party to recognize the loss
- The taxpayer can then donate the cash from the sale to a donee
Disposition by Death

A deduction for a passive activity loss is allowed to the extent that the loss exceeds the basis the beneficiary has in the interest in the activity over the adjusted basis the decedent had in the activity immediately before death.

The basis the beneficiary has in the interest is usually its fair market value at the date of the decedent's death (Sec. 1022 applies to taxpayers who receive property from someone who dies in 2010 and Sec. 1014 applies to taxpayers who receive property from a taxpayer who dies in a different year).
Example

• Dee C. Dent owned a limited partnership interest for which she had passive losses carried from prior years of $230,000 and a passive loss in the year of her death of $20,000 for total passive losses for the activity of $250,000.
• Her basis in the limited partnership interest at the time of her death in 2011 was $800,000.

Example

• The fair market value of the limited partnership interest was $940,000 at the date of her death.
• She bequeathed the interest to her son Ben E. Fisher.
Tax Result

• The tentative loss of $250,000 is limited to the step up in basis that Ben received in the interest.
• Thus, only $140,000 ($940,000 - $800,000) of the tentative loss of $250,000 is allowed.
• The remaining $110,000 ($250,000 - $140,000) of the loss is never deductible by anyone.

FMV Less Than Decedent’s Basis

• Assume that the fair market value of the interest was $750,000 rather than $940,000 at the time of the death of Dee C. Dent.
• Ben E. Fisher’s basis in the interest would be $750,000.
• None of the $250,000 loss would ever be deductible.
Tax Savings Strategy

• If the taxpayer is terminally ill or otherwise has a short life expectancy, sell an interest in an activity with a passive activity loss to an unrelated party to trigger loss recognition
• Especially important if the FMV < Basis

Convert Passive Activity to Active Activity

Some activities may cease to be passive activities and become former passive activities if the taxpayer materially participates in the activities during the year
Convert Passive Activity to Active Activity

- Passive losses from prior years are deductible against the income from the activity (Sec. 469(f)(1)(A))
- Any remaining passive loss carried from prior years remains as a passive loss (Sec. 469(f)(1)(C))

Tax Savings Strategy

- Materially participate in a former passive activity
- Any loss incurred in the current year would not be a passive activity loss
Tax Savings Strategy

If the taxpayer realizes net income from the activity in the current year, the taxpayer may deduct passive activity losses from the activity carried from prior years.

Appendix 4

Seven Ways to Materially Participate
Seven Ways to Materially Participate
(Temp. Regs. § 1.469-5T)

• Participate in the activity for more than 500 hours during the year
• Is substantially all of the participation in the activity of all individuals for the year
• Participated in the activity for more than 100 hours during the year and the individual’s participation is not less than the participation in the activity of any other individual

Seven Ways to Materially Participate
(Temp. Regs. § 1.469-5T)

• The activity is a significant participation activity and the individual’s aggregate participation if all significant participation activities during the year is more than 500 hours
• The individual materially participated in the activity for any five tax years of the 10 taxable years before the current tax year
Seven Ways to Materially Participate (Temp. Regs. § 1.469-5T)

- The activity is a personal service activity and the individual materially participated in the activity for any three tax years before the current tax year.
- Based on the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year.

Appendix 5

Significant Participation Activity
Significant Participation Activity

- Trade or business activity in which the individual significantly participated and
- Would be an activity in which the individual does not materially participate for the tax year if not treated as a significant participation activity (Temp. Regs. § 1.469-5T(c)(1))

Significant Participation Activity

Must have participated in the activity for more than 100 hours during the tax year (Temp. Regs. § 1.469-5T(c)(2))
Appendix 6

Personal Service Activities

Personal Service Activities

• Health
• Law
• Engineering
• Architecture
• Accounting
• Actuarial Science
• Performing Arts
• Consulting
• Others if capital is not a material income-producing factor