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Untaxingly Yours

One Hundred Years of Tax Planning

By Brian T. Whitlock

In 1849, French writer Jean-Baptiste Alphonse Karr wrote "plus ça change, plus c'est la même chose." Roughly translated the phrase means "the more things change, the more they stay the same."

In my nearly 43 years of tax planning as both an attorney and as a Certified Public Account, I can attest to the fact that Karr's statement rings true in the tax arena. Personally, I find tax planning to be fascinating. I love puzzles and to me the tax law is a giant puzzle. Whereas the traditional puzzle box cover contains a picture of the finished product of the assembled pieces, the tax planner's goal is building an outcome for the client that will result in the least possible amount of tax being paid. The pieces available to the tax planner are many and varied, but when organized correctly they all fit together with precision. In order to prevent the task from becoming mundane or repetitive Congress periodically changes the way the pieces of the tax puzzle fit together by changing the Internal Revenue Code. It is our job as tax planners to become master puzzle builders; embrace the challenge; and enjoy the game.

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The Fundamental Principles

Despite constant changes to the Internal Revenue Code over the past 100 years, the fundamental principles underlying tax planning have remained unchanged. Tax professionals who are proficient in these fundamental principles will have a quick common-sense way to not only analyze, but also dissect scenarios. I would suggest that there are a handful of fundamental tax principles that every tax professional needs to understand in order to be an effective tax professional. The first three principles involve the three "W's": "Who," "What," and "When" taxes are paid.

First Principle—Transactions Are Generally Balanced

On my very first day in public accounting, the managing partner of the firm taught me his primary principle of income taxes—"Transactions between taxpayers generally are balanced." In other words, if a payment in a transaction between two taxpayers results in an income tax deduction for one party, then the same item will likely result in taxable income for the other party. The mental image is like the scales of justice, as one side goes down the other side goes up.

For example, compensation represents a deductible expense for the employer, but at the same time it is taxable income to the employee. Similarly, if a payment is

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not deductible, then its receipt may be excluded from tax. Life insurance premiums are not income tax deductible, and correspondingly life insurance proceeds are generally excluded from taxable income.

This principle of balance contains what should be a simple truth. Over the years, it has provided me with a level of comfort in knowing that fairness generally lies at the foundation of income tax. It typically allows me to cut through all hype quickly and get to the heart of whether an idea or a strategy that is being "pitched" is built on common-sense principles or not.

Daily we are bombarded by sound bites in the media regarding taxes that the general public embraces as true but we know a patently false. Take for example the statement that "Large corporations like Amazon pays no taxes!" As tax professionals, we know that this broad-brush statement is ridiculous. The likely truth is that if you looked at one small slice of the pie, one year out of many, yes there might in fact be a year in which Net Operating Losses and credits reduced or eliminated the corporate income tax for a company. However, full explanation is tedious and does not fit neatly in a sound bite. The reality is that expenditures were incurred before the start-up company had significant revenue. The losses and tax credits are only available, because the company spent millions of dollars doing something that the government might have had to pay for directly. Starting new industries, creating new technology and innovation, keeping people employed during pandemics, research and development if paid for directly by the government would cost taxpayers four to five times the amount that a deduction at the applicable tax rate saves a corporation.

There are always exceptions, and times when things do not balance, the most recent came in the form of the Consolidated Appropriations Act which was signed by the President on December 27, 2020. The Act clarified that qualified payments made with the proceeds of Paycheck Protection Program (PPP) loans would be income tax deductible at the same time that forgiveness of the PPP loan would be excludable from gross income. The Act yielded a double benefit for taxpayers, a highly unusual result, but Congress determined that in a time of economic crisis it may have set back the recovery further if the double benefit was not granted.

Second Principle—Divide and Conquer

In a graduated income tax regime, if a receipt will be taxable as gross income, then it will generally be advantageous to have the taxpayer with the lowest marginal income tax rate earn the income and pay the tax.

Income tax rates from the 1930s throughout the 1970s ranged from 60% to 90%. During this fifty-year period of time, tax planners frequently employed the principle of "Divide and Conquer." Tax planners created multiple entities (*i.e.*, C corporations, S Corporations and trusts), each with varying permutations and combinations of taxpayer owners, as a means of creating multiple sets of graduated income tax brackets over which income could be spread. Tax planners divided the gross income over numerous smaller taxpayers in order to lower the effective tax paid.

Beginning in 1981, Congress began to lower the top income tax rates, first from 70% to 50%, and then in mid-80s down to top rate of 28%. In the process, Congress compressed the marginal income tax rates for individuals and fiduciaries. At the same time however, the top gift and estate tax rate remained high at 55%. This inversion in the income and estate tax rates acted to invert the principle of "Divide and Conquer." During the thirty years that have followed, the highest marginal income rate has remained relatively low and the focus shifted to reducing (or avoiding) the estate and gift tax. Tax planners moved away from "inter-entity" tax planning, creating new taxpaying entities with low brackets. Instead, tax planners have shifted to "intra-entity" tax planning and focusing on "Who" pays the income tax. The analysis concluded that if the same relative income tax burden is present regardless of how many taxpayers are present, then perhaps other savings can result by placing the tax burden on one person over another. Given the high gift and estate tax rates when the income burden is forced to be paid by members of the older generation, then its payment will reduce the older generation's gross estate, lower the estate taxes payable, and result in greater net assets transferring into the hands of the younger generation.[1]

To achieve this end over the past 10+ years, planners have frequently created Grantor Type Trusts[2] as a way to keep the income tax burden with the Senior Generation, despite the fact that the Senior Generation may have transferred the assets to a trust for the benefit of the Younger Generation.

Third Principle—The Time Value of Money

When economic interest rates are high, excess cash can be invested and yield a high rate of return. Throughout the 1980s and 1990s interest rates fluctuated between 5% and 15%. During this period the mantra among tax planners

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was "Defer, defer, defer." In other words, postpone the payment of all taxes for as long as possible and invest the funds in the interim. In this simplistic analysis deferred taxes are treated like an interest-free loan from the IRS.

The Principle of the Time Value of Money is much more complex than simply focusing on tax deferral strategies. The relationship between the rate of interest and time underpins many sophisticated tax planning strategies. Planners need to understand that relationship and leverage it to the benefit of their clients.

When interest rates are high, the present value of the right to receive an asset in the future can be significantly depressed, and tools such as Qualified Personal Residence Trusts, Grantor Retained Income Trusts, and Charitable Remainder Trusts are effective. When interest rates are low, the present value of a stream of annuity payments is more valuable, and tools such as Grantor Retained Annuity Trusts, Private Annuities, Installment Sales, and Charitable Lead Annuity Trusts are effective. The ebb and flow of interest rates should change the planners focus and assist in choosing the proper tools.

During the last decade interest rates in the United States have fallen below 3%. In some European countries[3] even negative interest rates have prevailed. Negative interest rates are generally used by Central Banks as an attempt to stimulate the economy. When investors borrow money during a period of negative interest rates, they are credited with interest instead of being charged interest. Negative interest rates penalize taxpayers that deposit cash in banks by charging the depositor the equivalent of a storage fee.

Developing an appreciation of the relationship of interest rates and the time value of money will open the tax professional's eyes to many new and exciting tax planning options.

Look Past the Hype and the Hysterics

Earlier this week a client sent me a magazine article which suggested that people who created trusts in South Dakota could avoid paying tax. He asked me if this was true, as if I had failed to tell him about some amazing tax planning tool. A careful reading of the article showed that the benefits of creating trusts in South Dakota were two-fold: (1) South Dakota Laws created greater asset protection for individuals that were worried about getting sued. Some unscrupulous people were among those trying to shield assets from *bona fide* creditors. This statement while somewhat true offends most peoples' sensibilities, and clearly thieves and con-artists should not be able to benefit from such laws. The trusts can be pierced but it can take an enormous amount of litigation and the thieves are good at waiting it out. (2) Foreign persons creating trusts in South Dakota generally do not pay income tax on the trust income. The reality is that non-Residents and non-Citizens are generally not subject to U.S. taxation of income that they earn outside of the United States on their intangible income. Should it not be surprising or unusual that the result is the same if the foreign person creates a South Dakota trust? U.S. Citizens and U.S. Residents are subject to tax on their intangible income, and South Dakota trusts created by U.S. Citizens or U.S. Residents are also taxed on that trust income. My client and perhaps even the author of the article complaining about South Dakota trusts failed to read between the lines and appreciate the broad generalizations that the author was making.

Hate and fear make good sound bites. It is easy for these pundits to seek to destroy trust in a system of taxation that despite its flaws is built on a solid foundation. It takes time and effort to repair the cracks and build on that foundation.

The bottom line is that it is always easy for politicians and journalists to assume the worst and throw verbal stones at the Internal Revenue Code. Hate and fear make good sound bites. It is easy for these pundits to seek to destroy trust in a system of taxation that despite its flaws is built on a solid foundation. It takes time and effort to repair the cracks and build on that foundation.

ENDNOTES

1. The author acknowledges that Code Sec. 691(c) creates an income tax deduction for the estate tax paid on "Income in Respect of a Decedent" (IRD). This deduction while intended to lessen the burden of double taxation on IRD is not sufficient to fully compensate the family. First, it should be noted that the deduction under Code Sec. 691(c) is limited to the marginal Federal estate tax paid on the IRD. Code Sec. 691(c) does not permit a deduction for any State estate taxes paid on the IRD. Second, itemized deductions not subject to the 2% of AGI floor have nevertheless from time to time been limited by the Pease limitation of 3% of AGI applicable to high-income individual taxpayers. Third, low-income individual taxpayers who do not itemize would lose the benefit entirely.
2. Code Secs. 671 through 679.
3. The Central Banks of Switzerland and Denmark currently have negative interest rates.

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