Looking ahead to 2014

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Taxpayers have now filed their personal income tax returns or extensions to file their returns by the Oct. 15 extended due date. With that pain in mind, it is time to begin the planning to impact the federal and state income tax returns due April 15, 2014. Hopefully those returns will reflect a more prosperous year. They will certainly reflect higher federal income tax rates since the top bracket has increased from 35 percent to 39.6 percent and there is now, in some situations, a 3.8 percent tax on unearned income. And we are still getting used to the new top California rate of 13.3 percent introduced in 2012. So what income tax planning is available?

The safest planning that provides large income tax deductions remains a defined-benefit pension plan. A properly conceived and operated plan can generate a $250,000 or more deduction for the business owner, with an acceptable cost to cover the employees. The plan's earnings are tax deferred and protected from virtually all creditors. When the owner's children can be employees, the results can be truly spectacular.

Internal Revenue Code Section 831(b) permits a small insurance company to receive up to $1,200,000 of premiums without paying tax. The business owner, or a trust for the owner's children, can own the insurance company, to which the closely held business pays the premiums. The primary motive to establish a "captive" must be nontax, e.g., the ability to achieve premium stability, increase claims control, and recapture underwriting profits. Once the business purpose threshold is achieved, the estate tax, income tax and asset protection benefits are outstanding. A handful of our lawyer clients have established captives with legitimate deductions of $400,000 to as much as $1,200,000. A captive is a business and must be operated as such, and that can be accomplished with proper guidance.

An extremely safe technique is a charitable remainder unitrust (CRUT). The tax advantages are so strong that a charitable motive is unimportant. Assume a single lawyer, age 55, invests $100,000 in tax-free municipal bonds earning 5 percent; contributes the bonds to a CRUT; and retains the income for life. Congress provides a $31,734 charitable deduction. In a combined state and federal 50 percent tax bracket, the actual investment in the CRUT is $84,000. That means the $5,000 per year payout is effectively a 6 percent tax-free rate of return, equivalent to a 12 percent pretax rate of return. That will be superior to most other investments. For a 65-year-old, the increased deduction increases the return equivalent to 13 percent. There are other charitable structures, including a charitable lead trust and a charitable LLC, which are worth considering, especially for those with charitable inclinations.

Life insurance with a tax-free buildup of cash value is a big winner under the new tax laws. Instead of thinking of life insurance only as a way to deliver a death benefit, think of it as an alternative investment to enhance your retirement. Compare life insurance to a pension plan: pension contributions are deducted; the assets accumulate tax free; and distributions are taxed as ordinary income. By contrast, premiums paid for cash value life insurance are not deductible; assets accumulate tax free; and money can be borrowed (no tax on a loan). Most people are hypnotized by a pension's deductions.

Monday, April 15, 2013

Criminal
Defense tactics in KPMG insider trading case raise legal eyebrows
Defense attorneys' transparency about their clients' wrongdoing in relation to the government's insider trading case against a former KPMG LLP partner have raised a few eyebrows among white collar criminal defense lawyers.

Corporate
Tax board's retroactive ruling irks startup investors, advisers
In December, the Franchise Tax Board decided to eliminate a tax deduction for people who buy, sell or invest in startup companies - an incentive that had been in place for two decades. Now some businesses are biting back.

Tax
IRS disclosure program growing despite obstacles
Since 2009, 38,000 individuals have voluntarily disclosed their foreign financial accounts, taking advantage of a special amnesty program that provides taxpayers an opportunity to comply with U.S. tax laws and avoid prosecution.

Law Practice
On the Move
Fox Rothschild LLP added John E. Mason Jr. and Jonathan B. Altschul as partners in the firm's Los Angeles office. Both joined from Glaser, Weil, Fink, Jacobs, Howard, Avchen & Shapiro LLP.

Bankruptcy
Brobeck, Paul Hastings fight over profits
Ten years after creditors pushed San Francisco law firm Brobeck, Phleger & Harrison LLP into bankruptcy, the defunct firm's Chapter 7 trustee Ronald Greenspan has one remaining lawsuit before the bankruptcy can conclude.

Howrey estate sues Cigna, Ceridian in clawback attempt
The Howrey estate has sued several vendors, including Ceridian Benefit Services Inc. and Cigna Healthcare Inc., in hopes of recovering substantial sums the firm paid them after creditors filed a petition forcing the firm into bankruptcy.

Tax
UK's tax man tries to woo local businesses
The U.K.'s top tax policymaker was in California last week promoting his country's recently-lowered corporate tax rate, new tax breaks for intellectual property transactions and tax incentives for small businesses making additional hires.

DOMA and a bizarre tax bill
Strangely, a nonearning same-sex individual may be required to pay taxes he or she should not otherwise owe. By **Emily J. Kingston and Patricia A. Cain**

India seeks to tax offshore transactions involving Indian assets
The harsh results of the new law, especially its retroactive application, have made the situation

However, the tax-free borrowings available from an insurance policy can make it economically superior.

[I]t is time to begin the planning to impact the federal and state income tax returns due April 15, 2014.

Another insurance product favored by the new tax law is the tax-deferred annuity: contribute money now (not deductible); the funds accumulate on tax-deferred basis for as long as you wish; and when the money is distributed to you, it is partly tax free as a return of capital and partly taxable as interest. Similarly, the new tax law has made a big winner out of stocks that pay no or low dividends but have high appreciation potential, and well-situated raw land with high appreciation potential (beware of Palmdale).

Of course, most people are well-advised to stop thinking about saving taxes and focus on building wealth. To do that you can do something as simple as pay tax, build up a nest egg, buy the house next door and rent it out. More wealth has been made in California, and most wealth is transmitted in California, through real estate than by any other medium. Of course, the tax laws highly favor real estate. Two major examples are: (i) depreciation, which is one of the few noncash deductions available in the Internal Revenue Code; and (ii) tax-deferred exchanges, which allow you to dispose of an asset, acquire a new one, and not pay tax on the gain.

There are other heavily tax-advantaged investments. Oil and gas partnerships usually allow the investors to deduct 100 percent of their first-year investments. Careful analysis will help you locate a partnership drilling in proven fields which will result in payouts of 5 percent to 12 percent for several decades. As to natural gas, you should know by now that the U.S. is "the Saudi Arabia of natural gas." Farming syndicates are starting to sprout. And our wealthy clients are investing in acreage needed to raise grapes, pistachios and avocados.

Finally, since 1988 "C" corporations have been rare in closely held businesses for a variety of reasons. However, they will be getting more attention now since their income is only taxed at a 15 percent rate on the first $25,000; 25 percent on the next $50,000; and 34 percent up to $10,000,000 (compared to a 39.6 percent rate for personal income over $250,000). "C" corporations will be selected by businesses which (i) can benefit from accumulating capital, e.g., building up inventory and equipment; and (ii) are unlikely to have an exit strategy consisting of a sale of the corporate assets.

Given the new 39.6 percent maximum federal personal income tax bracket; the new 3.8 percent tax on unearned income; and the still new 13.3 percent maximum California tax, income tax planning is more important than in 2012, and now is the time to engage in planning for the returns that will be due in less than 12 months.

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Tax traps at the border
California has taken dramatic steps to negate the benefits its businesses and residents previously enjoyed by "moving away." By **Michael Kearney**

Internet sales tax held constitutional
New York's Amazon sales tax - requiring tax collected at time of purchase by online sellers with affiliate programs - has been held constitutional by the New York Court of Appeals. Does California care? We should. By **Robert W. Wood**

Looking ahead to 2014
Hopefully 2013 will be a more prosperous year, as the top bracket has increased from 35 percent to 39.6 percent and there is now, in some situations, a 3.8 percent tax on unearned income. By **Bruce Givner and Owen Kaye**

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General Counsel for Alorica Inc. Irvine

Judicial Profile
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Tax
Foreign investment in REITs on the rise
While foreigners are subject to a 35 percent FIRPTA tax upon the disposition of U.S. real estate, foreign investors are increasingly using a tool that allows them to invest in real estate - in a way - while bypassing FIRPTA.