LAW OFFICE OF GERALD R. NOWOTNY, PLLC

# KNOCK YOURSELF OUT

## RESUSCITATING TAXPAYERS WITH BUYER'S REMORSE!

A thousand apologies to the generous readers who continue to put up with me and read my articles! My mother and father (of blessed memory) thank you! I was largely out of writing commission during the month of December suffering the indignity of having to make a living rather than waxing poetic articles or pontificating on one thing or another.

Those of you who read my blog and articles know that I am a huge Tower of Power fan. In my youth, I played the baritone horn and trombone in band and orchestra without much or any fanfare. On my best day, I was a mediocre musician. Nevertheless, I have loved all of the horn bands - Blood, Sweat and Tears, Chicago, and Tower of Power (TOP). However, TOP is special. They deliver soul and funk like Earth, Wind and Fire and Soul Brother #1, the godfather himself, James Brown.

TOP has supplied horns for Santana, Elton John, Huey Lewis, and many other performers in the recording studio. Sting is known to have said that he always aspired to be in a band with a sound like TOP. He succeeded! The Berklee College of Music has a course in the course curriculum and student ensemble studying the TOP. If TOP has not been on your playlist, it is a "must add" in 2021. Having said that it may be the only thing that you remember about me!

**Tax Planning for the 2020 Tax Year in 2021**

One of the feelings that all of us living on the Planet including those who have walked before us, experience is the remorse for actions taken or sometimes not taken, i.e., buyer's remorse. Individual taxpayers report their income on the calendar year (January 1-December 31). Normally after December 31st, the year is closed, and it is too late to implement a qualified retirement plan.

Due to the economic turbulence created by the Covid-19 pandemic, Congress has created an opportunity to do some tax planning after the fact. Thanks to the Secure Act, any profit sharing or pension plan has up to the tax filing date (April 15th) plus filing extensions to be adopted. Consequently, any taxpayer has until September 15, 2021 if a company's normal filing deadline is March 15, 2021.

On one level, it appears obvious that a taxpayer with an existing business still has time to adopt a qualified retirement plan. What is less obvious is the possibility of "Chip", the investment banker from Goldman Sachs with W-2 income from Goldman of one million dollars and outside investment income of another one million dollars, adopting a new qualified retirement plan featuring a cash balance defined benefit plan, profit sharing and Roth 401k plans, and a 401(h) post-retirement medical plan, allowing Chip to offset the entire amount of the investment income with a tax-deductible contribution into a qualified retirement plan sponsored by his personal investment holding company. It does not matter that Chip thought of this after the fact in 2021! This scenario can be replicated at any level of income.

**Case Study - Facts**

Wile E. Coyote, age 55 and his wife Mary, age 55, have been married for thirty years and have two children – Wile E., Jr., age 25 and Sally, age 27. Wile E. Coyote works for an investment banking firm on Wall Street and has W-2 income of $500,000 per year. His company provides matching contributions to the Company's 401(k).

Wile E. Coyote and Mary have $250,000 of investment income each year based on their real estate investments and Wile's private trading income for their own investment account. Most of this income is taxed at ordinary rates. Wile E. Coyote would like to maximize his retirement income while reducing his current taxation. He is a resident of New Jersey and in a combined marginal tax bracket of 47.5%.

**Case Study - Planning Solution**

Wile E. Coyote creates a family investment company to manage his family investment income. The corporate structure involves the creation of a new family limited partnership (Coyote Family Limited Partnership) which has a corporate general partner – Coyote Family Office, Inc.; Wile E. Coyote and Mary own a 99% interest in the LP and the corporate general partner will own a one percent interest in the LP but has 100 percent of the management and control of the LP. The GP is established as a regular corporation with a November year end.

Each investment activity is owned in separate LLCs whose ownership is transferred to the LP. Each real estate holding is owned within a single member LLC. The trading activity is transferred to a single member LLC and transferred to the LP. The LP pays a management fee each year to the GP equal to its investment income. The GP will use this income to fund a qualified retirement plan which consists of a cash balance defined benefit plan, profit sharing and Roth 401k. The initial participants in the Plan will be Wile E. Coyote and Mary. The children may be added to the Plan in the future.

The GP has a fiscal year end (November 30$^{th}$) which absent sponsorship of a qualified retirement plan would provide Wile E. Coyote and Mary with approximately 20 months of deferral of the management fee income ($500k) paid to the GP. The adoption of a cash balance defined benefit plan, and profit-sharing plan and Roth 401k allows the couple to make significant tax-deductible contributions into the Plan despite Wile's employment and W2 income. The Secure Act allows Wile E. Coyote to contribute for the 2020 tax year which has already closed.

Funding in the initial year will allow Wile E. Coyote and Mary to design the Plan so that Plan contributions equal the level of management fee income within the GP. The contributions consist of a cash balance defined benefit plan for Wile E. Coyote and Mary; profit sharing contributions and 401(h) contributions.

In 2021 (but not for 2020), the Plan allows Wile E. Coyote and Mary to use the tax savings to fund a Roth 401k up to $26,000 per participant ($19,500 each plus a $6,500 catch up contribution). The Plan may incorporate (if needed) double contributions in the first year of the Plan in order to maximize tax deductible contributions while minimizing taxable income.

**Summary**

On a personal level, I had a taxpayer (client) with $2 million with short term capital gain trading income at the end of 2020. He is a smart guy with a Harvard MBA except his name isn't Chip. He never imagined a planning scenario, and solution that could reduce his taxable income by the same $2 million dollars. The miracle is that a taxpayer who never thought he had a solution, now has a solution, after the fact and after the close of the tax year. This solution fits every size. What are you waiting for?