

## Windfall Income Tax Planning

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You receive a call from a very excited client: your lawyer client settled a large case. Or your client won a large judgment. Or your client won the lottery. Now your client is about to receive a very large check: \$1,000,000. \$5,000,000. More? That's the good news.


The bad news is that it is ordinary income, and large lump sums of ordinary income are taxed at the highest marginal rates and do not have easy tax planning "solutions."

What alternatives should you help your client consider? In this discussion we will use \$1,000,000, since you can multiply that figure by as much as necessary to make it interesting, and we will assume that all of it is in the maximum federal (and state) income tax brackets.

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First, if at all possible, see if your client can split the receipt of the funds between this year and next year. Of course be sure that deferral does not jeopardize receipt of the funds or significantly reduce the value of the second year's payment (due to the time value of money).

Why do this? Usually not because the client is likely to be in a lower bracket in the later year. Instead, this is because the best tax technique—a pension—works best when there are contributions in multiple years.

Second, seriously consider simply paying the tax and pocketing the difference. On \$1,000,000 the tax will be 39.6% federal, leaving \$604,000. In the highest taxed

state, California, the tax would be  $(13.3\% \times (100 - 39.6) = 60.4\%) = 8.0332\%$  net, meaning a total of 47.6332%, leaving \$523,668.

The advantage of this approach is the KISS principle: Keep It Simple. Your client can put the \$604,000 (or \$523,668) in the bank; in tax-free muni bonds; in first trust deeds on real property; or your client can buy a building, depending upon investment preference, all without worrying about "tax structuring."

Third, the most conservative tax structure is a pension plan. How much of a deduction can your client get? Probably a lot more than you think. A 45-year-old with a same-age spouse, both of whom have past service, can probably achieve a deduction of \$320,000. The figure increases to \$530,000 for a 55-year-old. There are ways to increase those figures. And there is a method that might allow that figure to triple in certain situations. (Of course, 99% of all plan consulting firms are not up to this task.) Pension plans are so safe and so important that it does not make sense to discuss other options until this one has been fully exhausted.

Fourth, a captive insurance company can be an attractive structure. A premium of as little as \$400,000 can be

economically appropriate, given the costs involved. And a premium of as much as \$1,200,000 can be received by your client's insurance company without incurring an income tax under Internal Revenue Code Section 831(b).

Of course, compared to the \$3,500 per year cost of a third party administrator for a two-person pension plan, the captive costs run 10 to 20 times as much. However, in the right situations, this can be a terrific result in terms of risk management, estate and gift tax planning, asset protection planning, and income tax planning.

Fifth, a charitable limited liability company is a way to get a deduction of 85 percent or so of the funds. This is primarily of interest to people who have a favorite charity that they would like to support. However, for those people, this is a wonderful result. The client ends up with an LLC that is full of money that can be used for investment, including loans for business opportunities; and the charity receives a steady stream of revenue for its membership interest.

Sixth, a charitable lead annuity trust, or CLAT, can create a large percentage deduction. For example, contributing \$1,000,000 to a 20-year term 5% payout generates an 88.436% deduction. For a 10-year term, the deduction is 46.853%. The cost of the upfront deduction is that the client is taxable on the trust's earnings. However, that cost can be mitigated by investing the trust corpus into muni bonds. Although it is not currently easy to find muni bonds at 5%, even if the bonds generate only generate a significant portion of the 5% payout this can be an excellent result, especially for a client who is interested in a particular charity and/or trying to fund his or her own family foundation. This structure is also attractive psychologically: the client gets a large upfront deduction and then, at the end of 10 or 20 years, gets all of the assets back, probably at a time when the client will appreciate them even more.

Seventh, a charitable remainder unitrust, CRUT, for the lives of two people both age 65 provides a 34% charitable deduction. The deduction increases to 49% if the couple are both age 75. Like the CLAT, this works well as a part of an overall tax plan for the client with the windfall. The advantage to the CRUT is that the client retains the income for life, which is especially attractive for clients who either have no children or whose children have already been otherwise provided for.

Eighth, investment in an oil or gas drilling partnership typically results in a deduction of 100 percent of the investment. The primary challenge is the economics, not the tax results.

Ninth, investments in real estate involving agriculture—such as grapes, avocados and pistachios—gives the advantage of the upside historically associated with land plus the heavy tax benefits provided by Congress to farmers.

Finally, when all else fails, buy a good building and use component depreciation. Depending upon the building, you may be able to depreciate up to 40 percent of the value of the building within the first five years.

When your client is about to receive a windfall of ordinary income, you need to review the list of alternatives. Leave your preconceptions at the door. Some clients will prefer to simply pay the tax. Some will be satisfied with a pension plan. But some few will want a meticulous analysis of all of the alternatives and will, in the end, surprise you by allocating funds to many of them.

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