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Capital Gain Tax Is Voluntary

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Arnold Schwarzenegger said: "From the time [people] get up in the morning and flush the toilet, they're taxed. When they go get a coffee, they're taxed. When they get in their car, they're taxed. When they go to the gas station, they're taxed. When they go to lunch, they're taxed. This goes on all day long. Tax. Tax. Tax. Tax. Tax."

Most taxes can be minimized. Keeping property and transferring it to your children can limit property tax increases.. Since Proposition 13 became law in 1978, the share of property taxes paid by homeowners, compared to businesses, has increased because real property owned by businesses is so seldom sold. If you are wealthy, you can eliminate payroll taxes by not working and investing in municipal bonds. A similar analysis applies to income taxes. And estate taxes do not apply to 99 percent of the population and are voluntary.

There are many ways to eliminate the capital gain tax, which is strictly voluntary. For example, most people believe that the tax deferred exchange under Internal Revenue Code Section 1031 is limited to real property. However, the Internal Revenue Service ruled that the exchange of Federal Communications Commission (FCC) radio licenses for an FCC television license qualifies. The IRS also ruled that the transfer of intangible property can qualify. These rulings were for individual taxpayers and may not be cited as authority. However, they illustrate that the statute is not limited to real property.

Tax deferred exchanges apply to property used in a trade, a business or for investment. What if your personal residence gain is too large to be sheltered by the $250,000 per person exclusion? Move out and rent it for a few years to convert it from personal use to investment or business use. Then sell it and exchange it for an apartment building. Borrow on the apartment building to fund the acquisition of your new residence. As with all tax planning, do this with care and a professional's guidance. As the famous oil well firefighter Red Adair said, "If you think it's expensive to hire a professional to do the job, wait until you hire an amateur."

Other exchange provisions are not as well know since they are of narrower scope. Internal Revenue Code Section 1035 permits the exchange of insurance policies and annuities without the recognition of gain. Internal Revenue Code Section 1041 permits the transfer of property from an individual to a spouse or former spouse without the recognition of a gain if in connection with a divorce. Internal Revenue Code Section 1042 allows the owner of a closely held business to sell stock to an employee stock ownership plan and reinvest the proceeds in stock or bonds of another corporation, typically a public company, without recognizing a gain on the sale.

Another way to avoid capital gain tax is to take advantage of one of the most attractive structures created by Congress: a charitable remainder trust.

SPECIAL REPORT

Top Women Lawyers

Our annual list of the Top Women lawyers in the state.

Thursday, May 12, 2011

Discipline
Receiver Sues Sedgwick For Malpractice
Sedgwick LLP has been hit with a $200 million malpractice suit over its work for accused fraudulent investment company Medical Capital Holdings Inc.

Health Care & Hospital Law
Former Biotech GC Acquitted
A U.S. judge acquitted former GlaxoSmithKline general counsel Lauren Stevens on Tuesday of all six charges against her in an investigation of the company's marketing practices for an anti-depressant.

Zoning, Planning and Use
The Curse of Chavez Ravine
Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

International
The Benefits of Bilateral Investment Treaties When Investing in China
Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson**, **Grant Hanessian**, and **Michiel Kloes** of Baker & McKenzie

Construction
What to Do With a Busted Project
Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

Letter to the Editor
America Is a Fair Country
Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal
Panel Lawyers Could Be Curtailed
A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

Judge Bars Gang Injunction Enforcement
A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

Another way to avoid capital gain tax is to take advantage of one of the most attractive structures created by Congress: a charitable remainder trust. Since it is so attractive, it is surprising that it is so underused. Many people are displeased by the idea of giving away property to charity and disinheriting their children. Therefore, charitable remainder trusts often go by the marketing term "wealth accumulation trust." So that the children receive something, a charitable remainder trust is paired with a "wealth replacement trust," a marketing term for an irrevocable life insurance trust.

How does a charitable remainder trust work? Why is it so attractive? There are four advantages. Mom and Dad, age 75 and 73, own an apartment building worth $2 million with a tax basis of $1 million, not subject to debt. They are tired of managing the building and want passive income. A sale will result in a $250,000 federal and state tax. They create a charitable remainder trust to pay a 5 percent annuity ($100,000) as long as either is alive. When the survivor dies, the balance will pass to the charity named in their family trust. First, they transfer the property to the charitable remainder trust, which sells the building and pays no tax. Advantage number one. Second, Mom and Dad receive a $716,000 deduction for the charity's right to receive the assets on the survivor's death. They can use that deduction to offset up to 50 percent of their adjusted gross income for the current year and the next five years. Assuming they have enough income to use the deduction, that may save them $320,000 in income tax. Advantage number two. Third, the charitable remainder trust principal is safe from creditors, advantage number three, although the annuity payments are not protected. Fourth, the principal is not included in their estates. If they have an estate that will be subject to estate tax, advantage number four is valuable. If Mom and Dad want their children to receive the after tax (both income and estate) value of the property, they can use some of the savings to buy insurance for their children. These four advantages are overwhelming to people who unemotionally analyze charitable remainder trusts.

Finally, death is the great capital gain tax loophole. If you hold appreciated property until you die, your heirs receive a basis equal to the date of death fair market value. Even under the 2010 tax regime of "no estate tax - no basis increase," there is a general basis increase of $1.3 million and a spousal basis increase of $3 million, which is enough for over 90 percent of the population. And, as indicated by the President, in 2011 we should be back to the "date of death basis" rules that prevailed in 2009, which will eliminate the capital gain tax for heirs on an immediate sale.

So if you pay capital gain tax it is your mistake. To quote the great John Wooden, "Failing to plan is planning to fail."

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Judicial Profile
Making Her Mark
A framed reproduction of Botticelli's Calumny of Apelles hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

Intellectual Property
Nevada Newspaper Pursues Copyright Cases
Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.

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