ACBA Section Spotlight: Business Section

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Would Your Client Ever Want To Pay Taxes Sooner Rather Than Later? Some Tips on Accelerating Taxable Gain in Anticipation of Future Rate Increases.

The Benefits of Deferral. Deferral, deferral deferral. It's one of the guiding principles of tax planning, drilled deep into the psyche of most business lawyers as they consider the income tax structure of transactions for their clients.

Normally, a lawyer's inclination towards deferring a client's obligation to pay income taxes is perfectly sound and economically rational. A gain deferred merely from December to January can sometimes allow a taxpayer to retain the use of his tax dollars for a full additional 12 months, permitting the taxpayer to invest those funds or to limit his borrowing needs. Gain deferral strategies can also effectively match the timing of a client's tax liability to the moment when the client actually receives cash from a deal that he can use to cover his tax liability.

The Changing Environment. We may be entering one of those very rare periods where the tax planning environment forces us to reconsider the normally unquestioned benefits of gain deferral. The United States has kept its maximum federal income tax rate on most long-term capital gains at a historically low level of 15 percent since that rate was introduced by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Initially, the reduced rate on long-term capital gains was to expire for taxable years ending later than December 31, 2008. Subsequent legislation extended the low rates, though, so that the current expiration date for the 15-percent rate is to be December 31, 2010.

We are, of course, in a presidential election year. And the low rate on long-term capital gains has been drawing a lot of fire as an unfair and unjustified tax benefit for the wealthy. Many observers believe that, under a President Obama, the rate on long-term capital gains might increase to 25 percent or more, though the Obama campaign recently stated that the rate would increase only to 20 percent. Some commentators have even suggested that a President McCain might feel significant political and fiscal pressure to raise the capital gain tax rate substantially above the current low rate of 15 percent.

The Historic Precedent – Increased Tax Rates on Capital Gains in 1986. The determination of the appropriate tax rate on long-term capital gains is not entirely a matter of doctrinal party politics. It's instructive to remember that the last President to successfully advocate an increase in the tax rates on long-term capital gains was Ronald Reagan. The Tax Reform Act of 1986, championed and signed by President Reagan, generally eliminated the tax-rate distinction between long-term capital gains and ordinary income, causing long-term capital gain to be subject to a maximum federal tax rate of 28 percent. The wider policy context of the Tax Reform Act of 1986 was a push towards a flatter tax with a broader base. But the dramatic increase in the tax rates on capital gains (from about 20 percent prior to the effective date of the 1986 Act to 28 percent) generated a lot of attention among tax and business lawyers who realized, while the new legislation was pending, that clients might be best served by recognizing capital gain before the effective date of the new rates.

Accelerating Gain – Judgment Calls. Deciding to accelerate a client's gain in anticipation of a rate increase is a delicate judgment. By structuring a transaction or making an election to recognize gain sooner rather than later, the client will be incurring a tax payment obligation more quickly than might be necessary given the client's overall business objectives.

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Accelerating gain will cause the client to surrender the time value of money. The client will pay his income taxes earlier, taking cash out of the client's business or investment portfolio. The current economic environment may be more accommodating to this loss than the economic environment was in 1986, since interest rates are now relatively low by historic standards. But even though interest rates are low, overall credit availability is tight, so any decision to accelerate gain must take into account the client's cash flow needs.

Also, many acceleration strategies will involve the client's recognition of gain prior to the time the client fully "cashes out" of an investment or business position. That is, the client might be able to structure a transaction to generate taxable gain at the time of closing on certain kinds of transaction even though the client's actual receipt of cash or other liquid assets might not occur until some point in the future. If the client stands to save a significant amount by avoiding a future tax hike, then acceleration can make sense. But an adviser must be sure the client has the wherewithal to pay any tax that is accelerated to an earlier year.

The good news about acceleration strategies is that many tax rules under current law are intended to limit deferral. The Internal Revenue Code has a strong and systemic bias against the postponement of tax payments. And where there is that kind of bias in overall legislative language, it tends to open planning opportunities for taxpayers who are deliberately seeking to move in the opposite direction. There follow a few planning tips to consider that might land a client's capital gain in an earlier, more rate-friendly taxable year.

Election Out of Installment Reporting. Installment reporting generally allows a taxpayer to report gain on a sale of property only when the purchaser pays for the property. If the purchaser pays in installments, the seller can often report gain from the sale only as he receives the actual cash payments. Installment sale reporting is normally not available for sales of inventory, and there are many other technical restrictions and limitations. Still, the ability to postpone the recognition of gain on a deferred payment sale is a significant tax benefit that can allow the deferral of tax liability.

What if a taxpayer does not want to defer gain, but wishes to report all of the gain on a sale for the year in which the sale occurred? Section 453(d) of the Internal Revenue Code provides a clear and direct answer: the taxpayer simply "elects out" of installment reporting. And significantly, for planning purposes, the election out occurs not at the time of the sale, but instead occurs on the taxpayer's tax return as filed for the year of the sale. The due date for the election out of installment reporting is the due date of that return, taking into account extensions of the time for filing.

Individual taxpayers normally report their taxes on a calendar year. The standard due date for such a return is the April 15th of the year following the taxable year. And extensions of that date are now routinely available through October 15th of the year following the taxable year.

Extending the time to file a tax return will extend the taxpayer's time to decide on electing out of installment reporting to October 15th of the following year. So, for taxpayers with 2008 installment gains who are concerned about possible tax rate increases becoming effective in 2009, it may be possible to wait on the acceleration decision until October 15, 2009. There is some risk that any such rate-increase legislation might try to foreclose this planning strategy, but this approach now seems like a viable one. Advisers should keep this in mind when discussing tax filings for 2008 and 2009 with their clients – there may be an additional reason (beyond mere procrastination) for extending the filing time of tax returns for those years if it appears possible there will be a significant change in capital gains rates.

Busting a Like-Kind Exchange. Real estate investors have long been aware of the tax deferral opportunities available through like-kind exchanges under Section 1031 of the Internal Revenue Code. Section 1031 generally permits a taxpayer to rollover gain from the sale of real property so long he reinvests the sale proceeds in like-kind property in accordance with a series of technical rules. Violation of those rules can lead to the seller's recognition of taxable gain from the sale.

One of the requirements for a deferred like-kind exchange is that the seller reinvest sales proceeds in like-kind property within the earlier of (i) 180 days from the initial sale or (ii) the due date (taking into account extensions of that date) for the tax return covering the year of the sale. This rule again creates some time for a seller to consider whether to accept the deferral, by completing his like-kind exchange on time, or to "bust" the exchange, by violating the 180-day requirement and reporting gain from the initial sale. Advisers should be aware that the timing requirements under Section 1031 may again motivate clients to extend the filing time for their tax returns so as to maximize the period to make a decision about the optimal year for their gain recognition.

Busting a Corporate Reorg. If a client plans to sell his corporate business in exchange for shares in an acquiring corporation, there is often some flexibility to structure the share swap either as a tax-deferred "reorganization" or as a fully taxable sale. To qualify as a tax-deferred reorg, there is a long checklist of technical requirements that the client must meet. Failure to meet the requirements can cause the corporate acquisition to be treated as a taxable sale of shares. A business owner might be able intentionally to structure the transaction to violate one of the reorg requirements, thereby permitting him to recognize gain currently and claim a stepped-up tax basis in the shares of the acquiring corporation.

Unlike the installment sale rules and the like-kind exchange rules discussed above, however, a corporate acquisition is either a tax-deferred reorg or a taxable sale as of the time the initial transaction occurs. There is no waiting period during which the taxpayer can look back and retroactively choose to place the transaction in either the deferred or the taxable category. So a lot of caution and foresight is required in the decision to deliberately bust a corporate reorg.

Corporate Liquidating Distributions to a Liquidating Trust. If a corporation is winding up, there are often good reasons to postpone final liquidating distributions. Legal wrangles must be resolved and creditors must be satisfied. Yet, if the corporation wants to allow its stockholders to report their full liquidating gains for the current year, the distributions must occur by December 31st.

In this situation, consider the use of a liquidating trust. The trustee will hold liquidating proceeds pending full satisfaction of any claims against the corporation. But the distribution from the corporation to the trust will normally generate gain taxable to the stockholders. Beware, however, of prematurely triggering gain recognition at the corporate level, especially if the corporation is a C corporation rather than an S corporation and if the corporation is distributing any assets in kind (including any installment notes with large payments due in the future).

Stockpile Potential Losses. Many taxpayers are in the habit of reviewing their investment portfolios towards the end of the year and selling investments that are showing a loss. This "harvests" the loss and allows the taxpayers to use the loss to offset other gain they may have recognized during the year.

But if tax rates on long-term capital gain are going to increase in the near future, capital losses will become more valuable if they are applied against those future gains. So when there are clear indications that rates are going up, a better strategy may be to forego the current recognition of losses and instead wait until succeeding years when the losses can be claimed with maximum benefit.

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One final word of caution: The strategies discussed above go against the grain of conventional tax planning and entrenched instinct. So be careful when using them. In the current political environment, though, it would be a mistake not to consider the impact of a potential future increase in capital gain tax rates.