PIF the Magic Dragon – Part II

A PIF for All Seasons

Overview

The first installment of this article focused on the bad news regarding limitations to Stretch IRAs as a result of the SECURE Act. This segment focuses on some alternative planning uses of the Pooled Income Fund ("PIF") which are less well known than the PIF. Readers are encouraged to review Part I of this article which covers the basic of the PIF.

Many of you that have read my articles know by now that I am a longtime enthusiast of the weight room and have never taken offense to the comment that "Nowotny knows squat". But of course! My wife (aka Long Suffering or Mrs. Nowotny) has always been mystified by the appeal of picking up heavy weights, unless of course, she needs me to move something in the house. Why not tennis, golf or sailing?

She is a tremendous aficionado of fine art and fine film and a great lover of history. She has saved me from a lifetime of B movies among many other things. I have seen every film and documentary about Henry VIII, Sir Thomas More and Thomas Cromwell because of her, whether I wanted to see it or not. The movie *A Man for All Seasons* about the struggles of conscience of Sir Thomas More won an Oscar in 1966.

The Pooled Income Fund is a PIF for all seasons. The tax attributes in the current low interest environment has stronger attributes than the charitable remainder trust ("CRT") for tax planning purposes. This article will outline some of the novel uses of the PIF.

A. The Poor Man's CRT

It is hard to avoid laughing at some of Rodney Dangerfield's jokes. His punchline, "I get no respect" could be the punchline of the PIF. The PIF has lived a lifetime in the shadow of the Charitable Remainder Trust, as the "Poor Man's Charitable Remainder Trust." Most pooled income funds sponsored by large public charities have largely been shut down over the last two decades and it is almost certain that the pooled income funds that remain, face extinction. So why bother writing an article about a planned giving technique that no one cares about anymore!

In the current low interest rate environment, one significant factor advantage of the PIF versus the CRT is the level of the income tax deduction for contributions to a PIF.

New pooled income funds that have existed less than three years have the ability to use to use an interest rate that is determined each year based on the three-year average of the IRC Sec 7520 rate minus one percent. In the current low interest rate environment, the difference in the amount of the deduction between the PIF and CRT is significant. In my professional opinion, the rate for PIF's is likely to fall significantly from 2.2 percent to at least 1.5 percent if not lower. This rate drop will make the already appealing PIF more appealing.

Age	PIF (2.2%) Current	PIF (1.5%) Assumed	CRT
40	44.7	57.1	17.5
50	53.9	65	26.1
55	58.9	69.2	31`.6
60	64	73.4	37.9
70	74.3	81.4	52
80	83.8	88.5	67.6

As a result, the creation and donation to a PIF has the ability to create a large tax deduction in the year of contribution with the ability to carry forward unused excess deductions five additional tax years into the future. Contributions of cash are currently deductible up to sixty percent of a taxpayer's Adjusted Gross (AGI). This planning construct allows a taxpayer to offset a substantial income realization event taxed at ordinary rates using the PIF.

B. Real Estate in a PIF Instead of an IRA

A number of taxpayers seek to own real estate within a self-directed traditional IRA or Roth IRA. A major limitation in this approach is the contribution limit into these accounts. As a result, the low contribution threshold forces the taxpayer to pursue debt-financing within the self-directed IRA in order to acquire the real estate. A major limitation of owning real estate within an IRA, is the presence of unrelated business taxable income (UBTI) in the event that debt financing is used to acquire the real estate. UBTI converts income that would otherwise be non-taxable within the IRA, into taxable income based on the percentage of debt financing attributable to the real estate.

The PIF is taxed as a complex trust and is not subject to UBTI. The taxpayer receives a tax deduction for the contribution of existing real estate within the PIF. The use of debt financing in the purchase of real estate will not create UBTI to the PIF. Real estate subject to debt financing will not create UBTI within the PIF.

The trustee of the PIF is able to use the depreciation tax benefits from the real estate as well as other expenses to reduce the amount of taxable income distributed to the PIF's income beneficiary. The sale of the real estate within the PIF will not generate any taxation to the taxpayer or PIF. Any depreciation recapture will also be avoided within the PIF.

Example 1- Real Estate within a PIF

John Smith, age 55, has always wanted to invest in real estate within his IRA but has been unable to create a strategy that does not rely of the use of debt financing. John has a plan to contributed existing residential real estate worth $250,000 subject to debt financing of $150,000.John transfers the real estate to a single member LLC and with the bank's permission, transfers all of his real estate to a new PIF subject to the indebtedness. He receives a tax deduction of $58,900. The depreciation and real estate expenses will help to shelter the income that is distributed to John as an income beneficiary. A future sale of the real estate will be non-taxable within the PIF.

C. Using the PIF in Marital Planning

IRC Sec 71 deals with the tax treatment of alimony. For divorce or separation instruments executed before January 1, 2019, payments constituting alimony or separate maintenance under IRC Sec 71(b) are included in the gross income of the payee spouse pursuant to IRC Sec 61(a)(8) and IRC Sec 71(a). An amount equal to the alimony or separate maintenance paid during the tax year is deducted by the payor spouse in computing adjusted gross income under IRC Sec 215(a).

Tax Reform in 2017 (Pub. L. 115-97, Sec. 11051(b)(1)(B)), struck Sec. 71, generally effective for any divorce or separation instrument (as defined in section 71(b)(2) as in effect before December 22, 2017) executed after December 31, 2018. This provision also applies to divorce agreements amended after December 31, 2018. Hence, alimony payments are no longer deductible to the payor spouse or taxable to the recipient spouse.

The PIF can serve as an excellent planning tool in divorce settlement planning as it lowers the cost of divorce on an after-tax basis by adding a considerable element of deductibility to cash or property in consideration of divorce or separation agreement payments.

Example 2

Mike Smith, age 55, is a successful business owner who is divorcing after thirty years of marriage. Mike's divorce agreement requires permanent alimony payments of $50,000. Mike has a commercial property worth $750,000 with net rental income of $75,000. Mike creates a new PIF and transfers ownership of a single member LLC which owns the commercial property. The charitable gift produces a tax deduction of $441,765 which may be taken up to 30 percent of adjusted gross income in the year of the donation. Excess deductions may be taken in five subsequent tax years subject to the 30 percent AGI threshold. Mike's after-tax cost is $308,235. Mike's ex-wife agrees to this arrangement in lieu of alimony payments. In the event the property is sold in the future, the trustee will reinvest the capital gains attributable to the sale without tax consequences. In the event, the PIF higher income than the initial payment, Mike's ex-wife will benefit from the higher payment coming from the PIF.

Example 3

Richie Rich, age 45, is involved in a legal separation from his wife. Under the terms of the agreement, he must provide child support payments of $2,000 per month for the next eighteen years. He must also provide alimony payments of $100,000 per year for life. The total payments between child and support is $124,000. Richie will transfer a two million portfolio of marketable securities to a new PIF. The deduction is $982,880. The portfolio is configured to produce a high level of current income – private equity mezzanine, REITs, direct lending el al that will comfortably generate the desired level of income.

D. Using PIFs for College Planning

The cost of four years of undergraduate education at a top private university is currently between $60,000-75,000 per year. The cost of law school including room and board a top law school is approximately $80,000 - $100,000 per year. Of course, these costs are currently non-deductible as personal expenses. Family members in my view might be more willing to assist children and grandchildren with these costs if there was a tax planning component to reduce the cost of a college education.

Example 4

Big Daddy, age 70, operated and sold a car dealership for a number of years in Alabama. He sold his dealership a few years ago for $20 million. He would like to set aside enough money to finance his grandson, Junior's, future college education at Harvard including three years of law school at Harvard Law School. Junior is currently age two. The annual tuition at Harvard in 2020 including room and board is $78,000 per year. The cost of Harvard Law including living expenses is $100,000 per year. Big Daddy does not want his son to rely on financial aid or a scholarship. The present value of the cost of an undergraduate education and law school at Harvard is $490,000. Assuming educational inflation costs of 8 percent, the future funding costs in Year 16 is $1.245 million. Big Daddy contributes $500,000 to a PIF. The tax deduction is $396,000.The funds will be invested on a tax-advantaged basis within an investment LLC that owns a private placement life insurance contract with a customized investment account that is expected to earn 8 percent net over the next 16 years. The PIF owns a preferred LLC interest that will pay the PIF a cumulative preferred return of six percent per year. This income may be taken in Year 16 and distributed on a tax-free basis. In the event, Big Daddy dies prematurely before he sees Junior walk across the stage at graduation, a portion of the death will be paid to a family trust for Junior. In the event Big Daddy is still alive, he may make tax free gifts of his tax-free PIF distributions directly to Harvard on Junior's behalf.

E. Using PIFs for Non-Qualified Stock Options

Companies frequently like to reward employees with non-qualified stock options ("NQSO"). When exercised, the company that grants the NQSO is entitled to a tax deduction equal to the gain and exercise. The employee picks up the "spread" as taxable income that is taxed at ordinary rates. Tax rates are already high and very likely to climb higher. The PIF is an excellent planning tool to mitigate the taxation at ordinary rates for the employee.

Example 5

Maximillian (Max), age 30, is the chief software engineer at Upstart, a new technology company in Silicon Valley. He generates NQSOs that generate $5 million in taxable income in 2020. He is a California resident and will be taxed at an approximately 50 percent rate. He is single and does not need the income from the investments currently. His mother who raised him is single and disabled and age 65. She could benefit from the income in the interim. He contributes $4 million to a new PIF that will provide an income to Maxamillian and his Mom. The contribution provides for a tax deduction of close to $2 million and will provide an income first to Max's Mom. At her death, the PIF will provide an income to Max for his lifetime. The PIF is structured using the planning from Example 4 – PPLI within an investment LLC using two classes of LLC interest. The investments will grow on a tax advantaged basis. The income to Max's Mom will be tax-free. The future income distributions to Max will also be tax-free. In the interim, he is able to offset a substantial part of his ordinary income resulting from the exercise of his NQSOs.

Summary

The PIF is a Man for All Season with a lot a "puff". IT is able to create substantially higher income tax deductions currently than a CRT. The differences in the PIF also make it possible to avoid UBTI treatment thereby providing greater investment flexibility. Similar This combination of tax benefits along with the income interests provide the possibility of considering a philanthropic tax solution for a new assortment of planning scenarios. Hence, the title of this article "PIF, The Magic Dragon.