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Devising Strategies

Congress enacted the estate tax in 1916 to apply to large fortunes at death. Eight years later, it added the related gift tax to cover transfers made before death. Both rates are currently 40 percent, and the first $5.25 million of an individual's wealth is exempt; the amount is $10.50 million for couples.

For as long as such levies have been on the books, lawyers have been devising strategies to get around them.

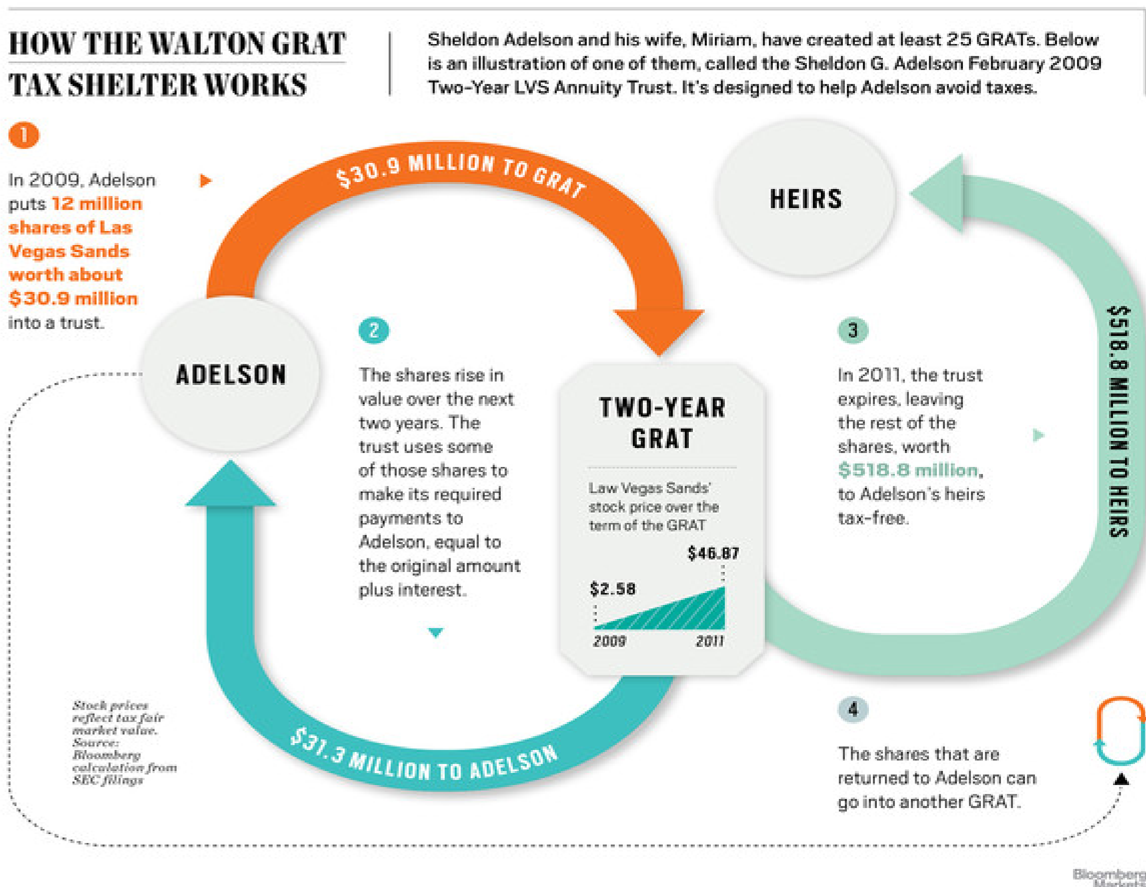
Congress created the GRAT while trying to stop another tax-avoidance scheme that Covey developed. In 1984, Covey, a lawyer at Carter Ledyard & Milburn LLP in New York, publicized an estate-tax shelter he'd invented called a grantor retained income trust, or GRIT.

Covey figured out how to make a large gift appear to be small. He would have a father, for example, put investments into a trust for his children, with instructions that the trust should pay any income back to the father. The value of that potential income would be subtracted from the father's gift-tax bill.

Zeroed-Out

Three years after the new law took effect, Covey created a pair of $100 million zeroed-out GRATs for Audrey Walton, the former wife of the brother of Wal-Mart Stores Inc. founder Sam Walton. The IRS, which had banned such GRATs through regulation, demanded taxes and took her to court.

In 2000, the U.S. Tax Court found in Walton's favor, determining the 1990 law didn't prohibit a "zeroed-out" GRAT. Covey had won a rare prize: an official seal of approval for a tax shelter.



Two years after Covey's court victory, Adelson set up a GRAT called the "Sheldon G. Adelson 2002 Two Year LVSI Annuity Trust," Adelson's SEC filings show. By 2009, he was juggling chunks of his fortune in as many as 10 GRATs at a time, filings show.

Adelson once discussed his approach to inheritance taxes in a legal deposition.

"Listen, the law says you can avoid taxes but you can't escape taxes," Adelson testified as part of a 1997 lawsuit over an unrelated business dispute. "We just want to do what is right, but it is prudent and it's wise to prepare your estate to save taxes."

Tax Loopholes

Five Ways Businesses and Individuals Beat the System

By Joseph Carducci 2013-12-18

You have no doubt heard the phrase that nothing in this life is certain except death and taxes...

While this may be generally true, there are, of course, some tax loopholes.

Obviously, no one wants to pay more in taxes than they have to and this is where tax loopholes come in.

Here are a few...

Avoiding The Estate Tax

This one challenges the very notion of paying taxes upon our death for the money left behind to our heirs.

Basically, it is possible to avoid paying taxes on money left to your heirs by taking advantage of a technique known as the Walton grantor retained annuity trust (GRAT). This was developed by a lawyer named Richard Covey in response to changes made in the 1990 tax code.

GRATs work by shifting large amounts of stock into a trust fund that is legally required to return that initial investment after two years. The stocks in the trust gain enough value that when it comes time to repay the initial investment, there is a substantial amount of stock left over that can be transferred on to a third party without triggering the gift tax.

The idea is that a client can put money into a trust with instructions to return the entire amount to themselves within two years. Since you do not need to pay tax on a gift to yourself, there is no gift tax incurred. This has been termed 'zeroing out' a trust.

Capital Gains Tax Break

While you might not immediately see this one as loophole, it is certainly one of the biggest and easiest benefits that people can take advantage of to lower their taxes. If you make an investment that produces returns, you are entitled to only pay a flat 15% tax on that return, no matter what tax bracket you would otherwise be in.

The main lesson here, is that it pays to structure your affairs in such a way that a larger portion of your income comes from investments rather than actual employment. Of course, you still need to be smart about what you actually invest in, but it should give you a lot of comfort knowing that you are looking at a lower tax rate on whatever income is generated in this fashion.

Deferral Of Overseas Income

It is not just individuals who benefit from tax loopholes, but also businesses. In fact, companies that have overseas branches can actually make profits in foreign locales and then leave them there, avoiding all U.S. taxes. According to the tax code, they will pay taxes on this money once it is transferred back to the US, but the reality is that it can often stay in the foreign location where taxes will be deferred indefinitely.

There is also a technique known as 'transfer pricing' that allows for the easy movement of those profits back home without incurring tax.

Basically, the parent U.S. company could sell something to their foreign partner (or subsidiary) and then that foreign company charges the parent larger licensing fees. The business can then deduct those licensing fees from their U.S. taxable income. Since this would simply be a bookkeeping entry, it is a great way to continue avoiding the tax and most of the top publicly traded companies in the U.S. use these practices.

Last-In, First-Out Accounting

Another way that businesses avoid taxes is through the use of last-in, first-out accounting. This simply means that if your business is engaged in buying items for a low price and then reselling them for higher prices, you can use the last item bought for your cost basis.

For example, if you have products for sale that were purchased at $20 a few years ago and more that were purchased at $30 last week, you can assume that the next item you sell is one of those that were bought at $30.

This type of accounting technique reduces your overall profits. Reduced profits means less reportable income and lower taxes. It is certainly an interesting business deduction that many different types of industries and organizations might want to consider.

Who Benefits From These Loopholes?

The biggest winners from many of these loopholes will be people in the middle class or above. Obviously, if there is no extra money to invest it will be extremely difficult to take advantage of things like the capital gains loophole. Homeowners are also able to capitalize on some of these. So are business owners, even small businesses. The real key is simply knowing what is available and how things can be used to your advantage.

After completing his education at Franciscan University, Joseph Carducci worked in a variety of positions in the investment field, ranging from stockbroker to trader to investment analyst. He is currently a professional investment writer who enjoys international travel and exploring different ideas (investment or otherwise) no matter where it may take him.