SEASON 2, EPISODE 18

TAX UPDATE & THE BILLIONAIRE'S TAX TACTIC YOU CAN USE

David Mandell:

Hello, I'm David Mandell, host of the program. We've got a special episode today. As this comes out on April 14th, I wanted to do a special tax episode. And so we have brought back my partner, Carole Foos, who anybody familiar with OJM knows, and anybody who's been listening consistently to the podcast or reading our books know. So we'll put Carole's bio in the show notes. I won't go through it all here, but she's a CPA with 25 years' plus experience. She has always been on the tax side. She's the co-author of all of our books. She speaks as much as I do to medical societies. And maybe most importantly, she does OJM's and my taxes, so I have total faith in her.

So Carole, I'm going to turn it over to you. You're going to give a tax update. And then she's going to give the mic back to me, and I'm going to talk about something that's actually relevant to Biden's most recent proposal, which Carole's going to talk about. But I'm going to focus on the billionaires tax proposal and a tactic, a strategy that billionaires have been using, the ultra-wealthy, for years and decades that you and I can use and that many physicians use at OJM. And there's a lot of ways to do it, but yet a lot of docs I speak to do not. So that's what's coming after Carole does her update. So with that, Carole, take over.

Carole Foos:

Thanks. Back in the fall, in November, the House passed the Build Back Better Act. Obviously, at this point, it's not been passed by the Senate. It's not law. And that was actually a pretty big difference between what we saw in that House-passed act versus what President Biden had proposed even throughout his campaign and some of the other bills that we saw proposed last year.

So just recently, we're now seeing that President Biden has unveiled his budget for 2023, and it certainly does bring back some additional taxes, particularly on the wealthy. It includes raising the corporate tax rate, so on C corporations. So if you've got a business that's taxed as a C corporation currently, that's taxed at a flat rate of 21%. If you remember back before President Trump's tax law was passed, that was a graduated rate that went all the way up to 35%. For many of our listeners who might be physicians and own physician practices, it was a flat 35% rate as a personal service corporation.

So the current 21% rate, the proposal on the budget is to raise that rate to 28%, not necessarily unexpected. That's something that President Biden campaigned on when they were talking about some of these tax laws. Since he took office, some in Congress were proposing that that be limited to more like a 25% rate. So that's one thing that's being proposed in the 2023 budget. He has also proposed a 20% minimum tax on households with more than $100 million. So on the super wealthy, he's proposing that minimum tax to help offset some of the costs in this budget.

Good news, he has proposed bringing back some of the SALT limitations. So the state and local income and real estate taxes, again, in the Trump tax law that passed. Those used to be essentially unlimited as an itemized deduction. So for taxpayers who itemized, they could write off all of their state and local income taxes, all of their real estate taxes. That was very useful, particularly to tax payers in high-tax states, such as California, New York, New Jersey. The Trump Tax Act limited that to a total of $10,000. So we've seen taxpayers really be unable to deduct the majority of their state and local income and real estate taxes.

So the Build Back Better Act, actually the House-passed version, increased that $10,000 limit up to $80,000 until 2031, at which time it would go back to $10,000. So President Biden's proposal, again, gets rid of those limitations and brings back the state and local tax deductions. So I think that's an important thing that they're still talking about. That's a good thing for taxpayers. It's certainly something, I think, many of us would like to see, especially those in states with income taxes. So that's a pretty important one.

And then there's been some talk also again of raising those capital gains taxes back up to ordinary income tax rates. Now, this didn't get any traction with Congress. As they were speaking about some of the laws that passed in 2021, it did not get included in any way, shape, or form in the Build Back Better Act that was passed by the House. So I'm not sure that that will get much traction even now, but that is being talked about again.

And he's also calling again for raising the top individual tax rate for higher-earning citizens from 37% back up to 39.6%, which is what the top rate was prior to that Trump tax law being passed. So that's kind of a lot of the things that we're looking at in terms of tax impact on, I think, what our listeners would be impacted by.

David Mandell:

Yeah, that makes sense. And some of the things, some of these proposals, they don't die. They just come back, and maybe in the second round, they get passed. Of course, we'll see how Congress looks differently with the fall elections. It sounds like some of the things that we're working on with clients --and I'm going to talk about one strategy -- but also tax-loss harvesting, the things we do with clients on the investing side, nothing in the proposals that would impact that, is there?

Carole Foos:

No, there's really not. Another key thing that I didn't mention that was in the House-passed Build Back Better Act was taxing pass-through income, active pass-through income. So again, think for our physician practices or surgery centers that are taxed as S Corps or partnerships, particularly the S corporations, right now that ordinary income that passes through that's not taken in the form of W2 wages is not subject to Medicare tax or to the net investment income tax, which is a 3.8% tax just like the Medicare tax is. That House-passed version of Build Back Better would assess the net investment income tax on that pass-through income if you're what they considered a higher-earning taxpayer. I think it's over $500,000 of taxable income for joint taxpayers, $250,000 for single tax payers. So that would affect a lot of our listeners if that gets passed or somehow works its way back into the budget proposal.

David Mandell:

But that's not in this version of it?

Carole Foos:

Not in this version that I have seen.

David Mandell:

Got it.

Carole Foos:

So it was in the House-passed Build Back Better. So again, separate, right, because the Build Back Better was to fund some other things. This is just the 2023 fiscal year budget proposal.

David Mandell:

Yeah. That's a big one because it affects me and you and almost all physicians, as most are in S Corps.

Carole Foos:

Exactly.

David Mandell:

We still certainly see some C corporations as well.

Carole Foos:

Right. But that's probably more impactful than the rise in the corporate income tax for a lot of our listeners.

David Mandell:

Right. Right. For some reason, I see some old orthopedic practices that are C Corps, but I don't see many really across the board. So Carole, anything else before I take over?

Carole Foos:

No, that's kind of where we are now. Again, as with everything, we'll see. Where it starts and where it ends up are generally quite different. So we'll keep our eyes on it. And obviously, we'll keep people informed as things pass or as any of these major changes become law.

David Mandell:

Right. Excellent. So now I want to dig down into one strategy. Carole mentioned in the Biden proposal that the billionaires tax or this tax that would be assessed on basic asset values for taxpayers with over $100 million of income or $100 million of assets. I can't remember what the threshold is. But in any case, it's something that they proposed last year. It's a way to tax assets and not income. And the reason it's important is, and you've probably wondered this if you haven't read about it or learned, how can these clients who are worth hundreds of million of dollars or billionaires basically have no income or pay no income tax?

Now, part of it could be charitable deductions, et cetera, but that doesn't explain how they may have really almost no income, because if you don't have income, it's very hard to assess an income tax against it, right, even if you get rid of deductions and things like this. And the strategy behind that... When this proposal came out last year, a lot of articles were written. I'll refer to a couple of them if you want to go read them. But the concept behind it is something that wealthy people have been doing for decades. And maybe this proposal will become law and will sort of get around it.

But the good news is that physicians and myself and Carole can use this tactic, can use this strategy. And there's four kind of sub-strategies underneath that I'm going to talk about, and a lot of our clients are already using it. Some of you may be already and not really realizing it to some extent. But I really want to dig down into this and spend a couple minutes on it.

What is this strategy? Well, the articles and some professors named it in a very, a kind of catchy phrase: Buy, Borrow, Die... Buy, Borrow, Die.

And there's a USC law professor, Edward McCaffery, I think he's the one who... At least, he said he's the one who coined the phrase. And he said, "Once you're already rich, it's simple. It's easy. It's just buy, borrow, die. These are planks of the law that have been in place for 100 years."

And essentially, the number-one plank that we take advantage of when we're doing this, and I say we because I do this, is that loans and loan proceeds are not taxable. So once you understand that, there's a lot of ways to use it, right?

There's a Wall Street Journal article I would encourage you to read if you are interested in this, and it's called... The name of the article is Buy, Borrow, Die: How Rich Americans Live Off Their Paper Wealth. It was from the Wall Street Journal, July 13th, 2021. So I want to dig into what that means quickly and then give you four ways that you could be using this.

Buy: this is pretty simple. We all do this. For billionaires, this means create a company, a startup that becomes huge. Okay, well, that's not so easy to do. A Tesla, a FedEx, et cetera. We'll talk about those two billionaires in a minute. But for us and for physicians, this might mean just invest. It doesn't sound as good: invest, borrow, die. It doesn't have the alliteration, but it means the same thing. Assets that you build up, that you own, that you can borrow against rather than sell. I mean, that's really it. If you consolidated this to one sentence it's: Borrow against the asset versus sell the asset. Right? When you sell it, you're going to occur a tax. But when you borrow against it, you are not. Now, you're going to pay interest, and we'll talk about that. Okay. So that number one is buy, but we can also think invest.

Borrow: pretty simple, right? Borrow funds with the asset as collateral. Loan proceeds, as I've said, are not taxable. This has obviously become even more attractive over the last decade or so as interest rates have been low. But even as they tick back up, we're still historically low. And again, when you compare it to the tax rates, it's not close.

Die: Now, here's the third part of it, which is the least attractive, I guess, to the client themselves, which is die. That never sounds like a fun thing to do. But what we're really talking about is not dying to then screw the creditor and don't pay them back. No. This is a strategy not to screw your creditors or for estate tax. Okay, that's a whole other talk we have to do. But this is about capital gains taxes. Instead of selling that appreciated asset, if you die with that loan in your estate, then your heirs can now sell the asset to pay off the loan or refinance it or keep the loan going. We'll talk about that in a second. But even worst case, if they then have to sell the asset to pay off that loan, they're getting a step-up in basis, right?

So if you have a stock that you bought at $100 and you borrow against it when it's at $1,000 and then when you pass away, it's worth $5,000, the heirs inherit that. They can sell it, once the estate goes through, let's say for $5,100. Well, their gain is only that $100. They inherited it at $5,000. They sold it for $5,100. So they're paying a much smaller amount of tax, and then they can sell less assets to pay back that original loan and the interest, whereas when you sold it, you would have paid the full capital gains. And for many even states, you would have paid state income tax. So that's the final piece of the puzzle, that step-up in basis. And of course, the estate taxes and all of that can change, but this is what's been in place for years. And I'm going to tell you about some ways that you can do this without the die part, just the buy, borrow.

Let me give you a couple examples of billionaires who do this. This is just what's been published. I mean, I'm sure almost all of them do this.

Elon Musk. Okay, this is an article from Business Insider from May 2020. So this is two years ago almost. It was public that he had about a $550 million credit line to three banks backed by his Tesla shares. So that can pay for a lot of what he needs to do: his boat, houses, his planes, et cetera. $550 million tax free is pretty good. It's not whatever he's worth, 70 billion. But for his expenses, why would he sell anything, right? For him, selling the stock, it's zero basis essentially because he's the founder. Whatever it's worth now, he's going to pay all that in capital gain. Plus, I think he's a California resident, so all that in California taxes. Plus, he is giving up voting rights because he sells shares. So he would never do that, right? So just get a credit line and borrow against it. And I'm sure at his status, he's getting almost zero interest rate.

Another example, again, which was in the Wall Street Journal article, was Fred Smith, who's the founder, chairman, CEO of FedEx. He had pledged, at this point, this is back in July of 2020, $598 million of the company stock, about 23.4% of his holdings, for loans. Again, he's getting some income probably that's taxable to him as the CEO of FedEx. But if you notice how that's typically done, it's not that much cash. It's a lot of stock and what have you, or options. And he doesn't want more income. He just borrows against the stock when the stock goes up. That's like him being able to borrow more without any tax, right? So again, hundreds of examples. These are just two I wanted to pull out.

Okay. So we're not Fred Smith. We're not Elon Musk. So how can we use this? Well, there's a number of ways to do this, and again, I have to give the caveat, to evaluate any of these and see if they make sense for you and if they're reasonable, please work with an experienced professional advisor. Because we're talking about debt and how you use it, and assets, and your balance sheet. Obviously, it's what we help our clients with at OJM, and we'd love to talk to you about any of these. But it's key to get a good advisor.

I'm going to talk about four tactics that basically mirror this buy, borrow, die strategy.

1. Number one, a HELOC or a second mortgage. It's exactly the same, meaning you could decide -- And I know, I've done this -- I need to make some improvements on the house, or I want to go buy something. I could sell an asset that I have. I could go to OJM and say, "Sell some of my portfolio," and pay tax on it and then go use it. Or I could borrow against the value of my home. And obviously, HELOC rates and second mortgages have been at all-time lows the last number of years. And use that capital. Now, I'm paying an interest rate. And if I die, well, again, it's the same thing. That asset, if my heirs sell the home, they may get the step-up in basis.

   So again, with the home, you have a $500,000 capital gain exemption. Well, the details... Obviously, this is why we talk with you, but the concept is the same, that rather than selling an asset, I could borrow against an asset on my balance sheet at a low interest rate and avoid the capital gains on selling an asset. And I could pay it back in the future. I could pay it back when I eventually sell the asset, maybe when I'm ready to, rather than selling it when I need the money to do something. Or I could pass away, and my heirs could then deal with it, even refinance.

Now interesting, there's a federal law, if it's a primary mortgage, that the lenders have to work with the heirs. I mean, the heirs can take over that existing mortgage. Now, with a HELOC and second loan, it may be different. But this is why when somebody dies, the heirs don't have to sell the property right away. They can keep that mortgage going. So it actually allows that, right? I mean, it's actually furthering this ability to do that. So that's one concept. It's something probably a lot of you have done. And I'm sort of going from most common and, I would say, least powerful… not that they're not powerful… but to least common and most powerful.

2. The second tactic, which has become much more popular in the last number of years, is portfolio loans. I have done this myself as well, and we have this ability at OJM group through Schwab and Goldman Sachs. Some of our clients at OJM are getting very favorable loans against their portfolio, a credit line. And if they need to spend something, they don't have to come sell the asset. They can go borrow on the credit line at very favorable rates. And again, same thing, right? Rather than selling the portfolio that's high, if they passed away, their heirs would get a step-up in basis, and they could then sell those assets to pay them back. I inquired… The lender that we use is Goldman Sachs, and I inquired with them, and they said oftentimes they will get paid out of the estate when the estate settles, or sometimes they refinance it with the heirs.

   So it's exactly the same as what the billionaires are doing. And it's not just OJM who's doing this. Goldman Sachs… Here's a couple of quotes:

   "Goldman Sachs expects its lending business to the mass affluent, (ed: which include physicians million-dollar-and-more portfolios, and RIA clients, which is we're an RIA) to hit $10 billion this year as the wealthy take loans to cover taxes and all-cash real estate offers." We have clients who've done that. That was from Business Insider, November of 2021.

   "Morgan Stanley wealth management clients have $68 billion worth of securities-based and other non-mortgage loans outstanding, more than double five years earlier." And that was from the same Wall Street Journal article I referenced before.

   So this is extremely attractive to the right client with portfolios who need cash or want to do some other investing or buy some real estate, but rather than sell assets to do that or use taxable cash flow, they will get a portfolio loan. And some of these portfolio loans are better than the HELOC rates and second mortgage rates. So it's cheaper money. Again, same concept: buy, borrow, pay it back if you want to, pay it back on your terms, or die and let your heirs get the step-up in basis and then pay it off from those assets.

3. The next concept is one we've written about and spoken about before, which is just cash value life insurance. Well, how does that work? Well, I don't want to drill down into all the details, but essentially, if you've read our books, et cetera, you know that cash value life insurance is an asset that properly-structured can have a cash value, an investment portion. And that could be tied to the S&P. That could be tied to bonds. Lots of options. But whatever it is, it's an investment piece of the asset, of the cash value policy, the cash value. Well, that grows, if properly managed, tax free. Then how do you get the money out? Well, you can always get a return of basis, what you invested in. That can come back tax-free. But beyond that, what you're doing is you're taking a loan against the policy cash values. Okay? It's a loan.

   And I have a policy like this myself, and we've written about this in our book. Some policies are great for accumulation, but they're terrible for that loan strategy because the interest rates are high. My policy that I have, that many of our clients have, I think it's a guaranteed 0.25% interest rate, meaning 25 basis points, less than 1%. So whenever I want to pull that money out in the future, I can borrow at 25 basis points, essentially almost a zero-interest loan.

   Well, you say fine. That's great. You grow the assets tax free. They can come out tax free because it's a loan, and you're paying almost no interest. But you've got to pay that back. Well, the great thing about the cash value life insurance is you have two options. You could always pay it back, put more cash in, but very few clients do that. And my plan, and I have some significant policies, is not to do that. The money gets paid back from the death benefit.

   So if I have, let's just say, half a million dollars of cash value with a $3 million death benefit, I can take out almost all that $500,000, not all of it, and that's what we talk about in the books. You have to keep the policy in place. You have to do this right. That's why you work with a professional to manage it. But I can take lots of that money out, $450,000 let's say, out of that tax free. And what that means is when I die, my heirs aren't going to get $3 million. They're going to get $3 million minus $450,000.

   It's a way to use the death benefit in my life as part of this strategy, right? It's the same thing. It's invest, borrow, die. I mean, it's exactly the same. And I'm doing this myself, and many of my clients do it, many of our folks at OJM. And maybe that makes sense for you. And again, some of you are doing this, probably less than have HELOCs or second mortgages, maybe less than are doing portfolio loans, maybe more. But again, I think it's still an underused strategy for physicians, and again, it comes right off the same playbook as the billionaires.

4. Premium-financed life insurance. Now, when I do a cash value life insurance policy, I'm doing it, I'm investing in it with after-tax dollars. Okay? I have one that I put in a certain amount every month, sort of automatic. I have another that basically is part of a plan that comes out of bonuses, et cetera. But that's

all after-tax dollars. That's great. Pay my tax, invest, grow tax free, borrow out tax free, die, let my death benefit pay it back. Buy, borrow, die. Invest, borrow, die.

What if you could actually supercharge that by, instead of using after-tax dollars to invest in that asset that's going to invest, borrow, die, but you could borrow the money to invest in that asset that then you're going to grow tax free and borrow tax free and have the death benefit pay it off,? That is kind of an exponential application of this concept, and we have physician clients who've done just that. And if you have listened to the podcast for a couple of seasons, if you listen back earlier this season, I think it was the fall of 2021, look for the one where I interview Jason Odell. And I'm not looking at it right now, what season that was or when that was. But if you go through the list, look for where I interview Carole, my partner, and Jason about premium-financed life insurance. And the concept is exactly that life insurance I just talked about: invest, grow tax free, pull it out tax free, and then the death benefit pays it off.

But what you can do at very favorable rates... And it's not for every physician, okay? It's for ones who qualify and it makes sense for. You can borrow the money at very favorable rates. Just like most of you do not pay for their home in cash (Very few people are... More today than in the past, but very few docs have). They're using a mortgage. Okay? And the life insurance policy could be a 10 or 15-year payback plan with a loan, a series of loans to pay the premiums. And what happens is, as that cash value grows, eventually... It might be year 10. It might be year 12. It might be year 15. They can take the cash value out of the policy to pay back the loan in full. Now they've got the remaining cash value that can grow tax free and they can borrow against in retirement. So it is kind of a doubling of the benefit here. Borrow to invest, to borrow, and then die to pay it off. A really powerful strategy.

And there's four tactics now, four ways that you can use buy or invest, borrow, die in the same way that billionaires do. Some physicians are using one. Some physicians are using none. Some physicians are using a couple of these. If you're interested in speaking about more of this, we'd love to chat with you about it.

So with that, Carole, I wanted to dig down into that in a deep way. You gave a good high-level overview. Anything else we want to leave our listeners with?

Carole Foos:

No. I think it's a great time now to start thinking about your 2022 tax planning. Don't wait till the end of the year. Things like smoothing out your income or shifting income take some planning. So I just think it's a great time for people to really start focusing on it. Maybe look at the 2021 tax returns if that's been filed, and think about what they can do to reduce that tax bill in 2022.

David Mandell:

Perfect. So listeners, thank you very much for tuning in. Of course, as always, tell your colleagues. Spread the word around. And if you're a doc who thinks you might have some interesting things to say and you want to share some tips with your colleagues, I am always looking for docs to interview as part of the podcast. So just reach out, shoot me an email, and we can chat about it. Thanks. In another two weeks, you will get another episode of this podcast. Thanks for tuning in.