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A FEW DOLLARS THE IRS WON'T GET

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> *Last week Ted De Grazia gathered up 100 or so of his paintings, valued upwards to 1.5M, and set out on horseback into the rugged Superstation Mountains east of Phoenix Arizona, together with several rag tag friends, to start a roaring bonfire to reduce the art works to ashes. What prompted this dramatic protest was his opposition to federal inheritance taxes, which the artist complained, could reach 77% of the assessed value of his art works after he dies.* **Wall Street Journal; Friday, May 21, 1976**.

He stated to the WSJ, "Suppose I turn out something like Rembrandt and I die and Uncle Sam says it's worth a million dollars. Where does the estate tax money come from?"

Shortly thereafter, I was introduced to De Grazia (he preferred going by his last name) by his attorney to see if anything "professional" could be done about his taxes. Over the years and up until his death in 1982, I got to know him as a friend and a highly intelligent, but eccentric individual. At the young age of 35, I had much to learn from this friendship. He complained not only about the estate taxes but also the large amount of income taxes he and his corporation were required to pay. What could I do about this? Of course, I thought I could do everything to save taxes…and his life works. And, in fact, we did.

De Grazia Gallery in the Sun, at that time, was located on ten acres of land on Swan road and consisted of his gallery which displayed his paintings, a sales area which displayed and sold some of his reproductions, but mostly trinkets and copies – tourist objects. The Gallery was a major stop on a tourist circuit with busloads of tourists off-loading every day for their one-hour tour.

I immediately set about to accomplish my new client's mission, a challenging task for a young CPA. Looking back at what we accomplished over the next six years, even though some of our tax structuring would not work under current tax laws, we were able to reduce his and his wife's combined income and estate taxes by perhaps 90%. The result of that savings now is his legacy, a major single artist museum in Tucson Arizona which he constructed with his own hands (and lots of buddies). More on that later.

So, what were these magical solutions? Nothing more than carefully structured planning to minimize income and estate taxes.

First, I noted his C-Corporation (at that time S-Corporations were not used as much) was making substantial profit from the sale of his "original reproductions" and all of the "trinkets" sold in the Gallery's store. He was just starting to become well recognized, so sales and profits were multiplying. As were his taxes. He and his wife, who also worked for the corporation, took salaries of $10,000 each per year. The corporation paid income taxes on the remaining income at about a 50% tax rate.

None of our other professional clients suffered taxes the way De Grazia did. So why not implement the garden variety planning we used for our doctors and lawyers (even CPAs)? The answer was obvious. We increased both their salaries to a level appropriate of their creative abilities. Then we installed a Defined Benefit Pension Plan. At age 68 (his wife was slightly older) that created about $450K per year in tax deductions for the C- Corporation. Most of the employees were of a younger age, although "Colonel"

Chuck was even older than De Grazia and his contribution on a $20,000 salary as a bookkeeper was substantial. (Note, he retired years later with a large retirement benefit.)

By the time De Grazia passed away in 1982, we were able to accumulate over $1.2M each in the retirement plans.

I asked De Grazia what his ultimate goal was for his art and his financial accumulation. He said, he wanted to provide a place where his art could be displayed for future generations by common folk to see. After all, he was an "artist of the people." And if it could be endowed with his savings (now greatly enhanced by his lower tax rate) ordinary people could visit without having to pay an entrance fee.

The solution was the **De Grazia Art & Cultural Foundation** – A Private Operating Foundation- formed in 1978. This would provide a legal structure which could continue in perpetuity. Not only is a Private Operating Foundation unusual, but the manner in which it was to be operated on the grounds of the "gallery" in Tucson Arizona posed some significant tax-exempt application discussions. The Application for Exemption was submitted to the IRS, and after a number of discussions and document submissions, was approved in March 1979. As a tax-exempt organization, a 501(c)(3)) is not supposed to inure to the benefit of its benefactor. What stuck in IRS's craw was that there was a significant area in which his art objects were sold to the general public visiting the gallery. While typical for a normal museum, this "co-working" arrangement with his C corporation posed a concern that the museum would be used as a draw to enhance his gallery sales income. The gallery did not sell his originals and only occasionally sold reproductions. In addition, this was a single artist museum of which I could only find one other in the United States.

We solved the IRS concerns by physically segregating his "sales gallery" from the museum where his paintings were being displayed. The IRS examiner reviewing the exemption application concluded that the museum was not being used as a lead to sell paintings in the gallery. In fact, unlike most museums which have a sales area as you leave, our sales area was where you first entered.

The next step in our grandiose plan was to make maximum cash contributions each year (using the 50% of AGI limitations) to cut the individual tax rate from that increased salary in half. His C corporation had little remaining income or tax. Part of their annual income tax deduction was increased by contributing some of their stock in the C corporation (at its current value) to the Foundation. The contributions were "filled-up" by additional cash added from their after-tax salary.

Then came the time for estate planning. He and his wife, Marion, owned their stock in the C corporation, paintings and all other investments as community property, except for their retirement accounts in which they had individual balances. We determined that the original oil paintings and other original art objects, including original reproductions, were not owned by the C corporation since he had never assigned ownership of them to the corporation after he created them. The C corporation sold non- art copies of his creations, cards, and other "touristic" items under its license with him (documented under his employment agreement) and received royalties from licenses issued to reproducers of his art in the form of bell's, Christmas ornaments, figurines, etc. Thus, his and his wife's estates consisted of ownership of the C corporation, direct ownership of their art creations, retirement plan benefits, and savings from the salaries they earned.

Both De Grazia's stated on a number of occasions (to make sure they were serious about this) that they wanted the foundation to be the beneficiary of all of their assets, disinheriting their adult children and the surviving spouse (each had their own separate community share). The only exception was an education trust set up for his then young son, Domingo, to provide college education funds. Mrs. De Grazia was not aware of this account until after his death. This estate plan was executed through the use of a revocable trust for each of them. When he died in 1982, his community share of the estate plus his retirement plan benefit passed to the Foundation a 501(c)(3) organization. Thus, no estate taxes, and no income taxes on the retirement benefit. Marion died some years later (a long story for another time) and eventually her assets passed onto the Foundation.

An interesting aside is that a few days after he died, I received a call from the director of the gallery who was very stressed by the fact that they had opened a closet and found bundles of cash stuffed into Chivas Regal whiskey boxes. The story is that he never knew what to do with his after-tax salary, so after buying his "load" of whiskey, he stuffed the remaining cash in the boxes. The staff was very concerned that the IRS would take half of it or more in taxes. My instruction was to immediately deposit the cash, and I informed them that he always reported all his income and, because of his estate plan, there would be no tax at all on the money. They took it to the bank where it took all night to count the over $200K in bills. Perhaps, he should have bought more expensive whiskey!

Footnote: His son, Domingo, graduated as an aeronautical engineer, pilot and presently is a lawyer in Tucson, AZ when he isn't playing some gig with his guitar. He recently was elected a State Representative in District 10. The DeGrazia Foundation (name changed- another story for later) by 2007, after his wife's estate was settled, had accumulated total assets of $26M!

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