Advanced Sales Forum

Best Ideas
for 2023

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Roth IRA Conversions and IRA Relocation

Roth IRA Benefits

- Lowers overall taxable income long-term
- Tax-free compounding
- No RMDs at age 73 (new, new RBD)
- Tax-free withdrawals for beneficiaries
- More effective funding of the “bypass trust”
- For purposes of the NIIT, Roth IRA distributions are not included in NII or MAGI

PURPOSE OF STRATEGY: To lower income below “threshold amounts” over the long-term.

Reasons to Convert

- Taxpayer’s marginal income tax rate at the time of the conversion is lower than the taxpayer’s expected marginal income tax rate when distributions are to be received.
- Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.
- Suspension of the minimum distribution rules at age 73 provides a considerable advantage to the Roth IRA holder.

Reasons to Convert

- Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.
- Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax.
- Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates.

Conversion Types

- *Strategic conversions* – Take advantage of a client's long-term wealth transfer objectives
- *Tactical conversions* – Take advantage of short-term client-specific income tax attributes that are set to expire (e.g., low tax rates, tax credits, charitable contribution carryovers, NOL carryovers, etc.)
- *Opportunistic conversions* – Take advantage of short-term stock market volatility, sector rotation and rotation in asset classes
- *Hedging conversions* – Take advantage of projected future events that will result

Mathematics of Conversion

In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:

- The annual growth rates are the same
- The tax rate in the conversion year is the same as the tax rate during the withdrawal years

$$A \times B \times C = D$$

$$A \times C \times B = D$$

Mathematics of Conversion

	Traditional IRA	Roth IRA	Life Insurance
Current Account Balance	$ 1,000,000	$ 1,000,000	$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)	(400,000)
Net Balance	**$ 1,000,000**	**$ 600,000**	**$ 600,000**
Growth Until Death	200.00%	200.00%	200.00%
Account Balance @ Death	$ 3,000,000	$ 1,800,000	$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-	-
Net Account Balance to Family	**$ 1,800,000**	**$ 1,800,000**	**$ 1,800,000**

Note: Life Insurance should be held in an ILIT

Mathematics of Conversion

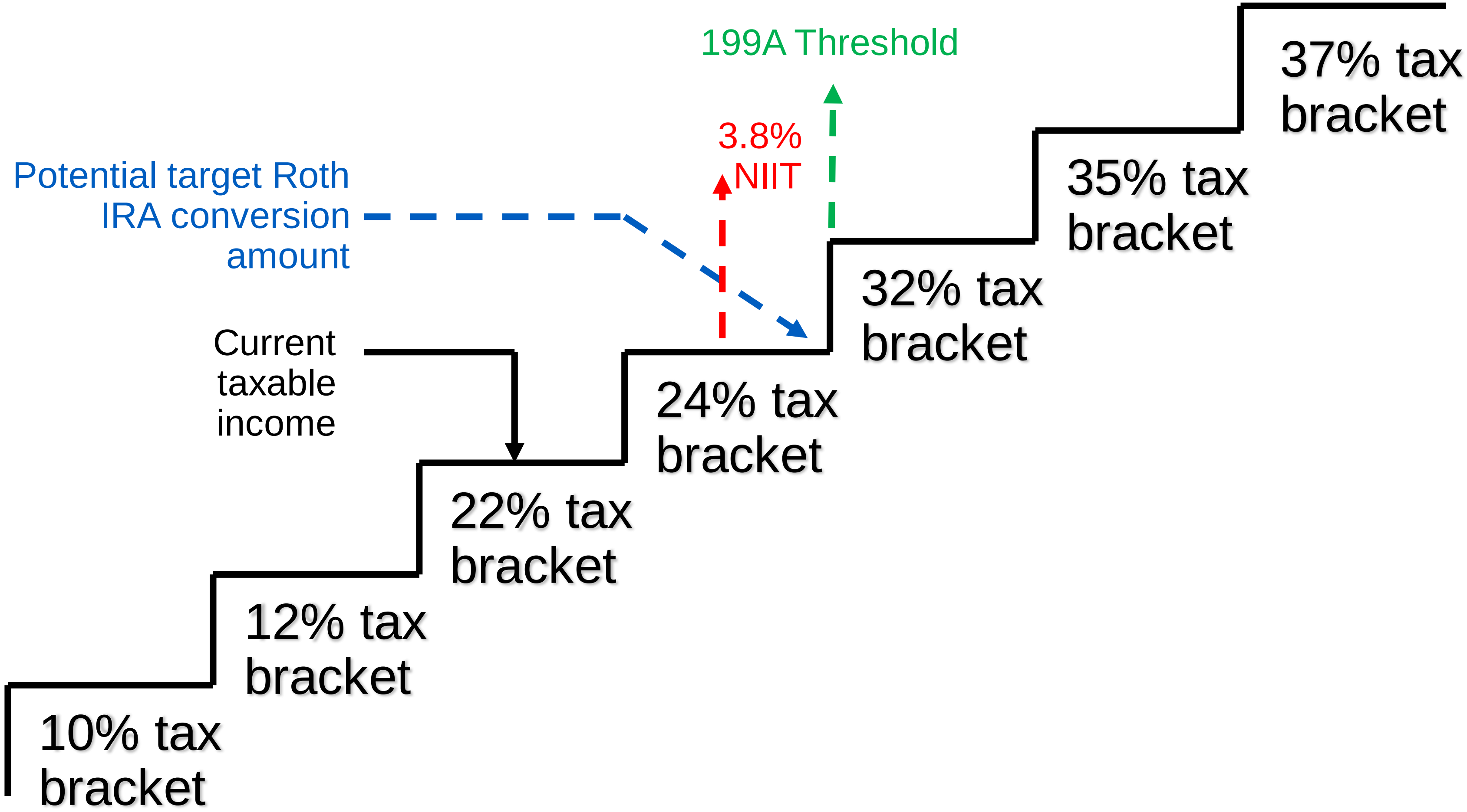
Critical decision factors

- Tax rate differential (year of conversion vs. withdrawal years)
- Use of “outside funds” to pay the income tax liability
- Need for IRA funds to meet annual living expenses
- Time horizon

Tactical Considerations

- Unused charitable contribution carryovers
- Current year ordinary losses; including PALs available after a disposition
- Net Operating Loss (NOL) carryovers from prior years
- Alternative Minimum Tax (AMT)
- Credit carryovers

Target Roth IRA Conversion Amount



Steps to Planning

Step 1: Develop a 10 to 15 year projection of income and deductions and compare these projections to the various taxes

Step 2: Develop an analysis to determine the client's "permanent tax bracket." Analysis will test whether an "intra-bracket" conversions increase the 3.8% surtax, the AMT, or Section 199A

Steps to Planning (continued)

Step 3: Develop a series of "bracket-crossing conversions" analysis. Each analysis must be measured autonomously standing on its own and take into account the other variables

Step 4: Repeat the above taking into account changes in value and the opportunity to recharacterize

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Strategy

- Wealth invested in an IRA, Roth IRA or in a life insurance policy have one thing in common, each of these Congressional devises is a statutory tax shelter

- A life insurance policy has the same basic income tax advantages as a Roth IRA.

- Tax-free withdrawals can be made from both—borrowing or basis-first withdrawals in the case of a life insurance policy and distributions in the case of a Roth IRA

- The starting point for the analysis is a comparison of the IRA owner's current/future income tax brackets

Two-Year Installment Sale

Overview

An installment sale is a type of sale in which the seller sells an asset to another person in exchange for a promissory note paid over a period of time. If executed correctly, the taxable gain recognized by the seller will be deferred until payments are made on the principal of the note.

PURPOSE OF STRATEGY: To spread out income and thereby decrease the average tax rate.

Overview

- IRC § 453 allowed for deferral of taxation on Installment Sales
  - $5,000,000 annual limitation
  - $10,000,000 annual limitation for married couple

- Gain is generally deferred until payment occurs
  - Depreciation recapture provisions – IRC § 453(i)

Basis Increase

- Sale from taxpayer to a non-grantor trust or a child receives a basis increase

- Basis equals the purchase price

Two-Year Rule

- IRC § 453(e)(2) provides a sale by a related party within two years results in realization of the original deferral

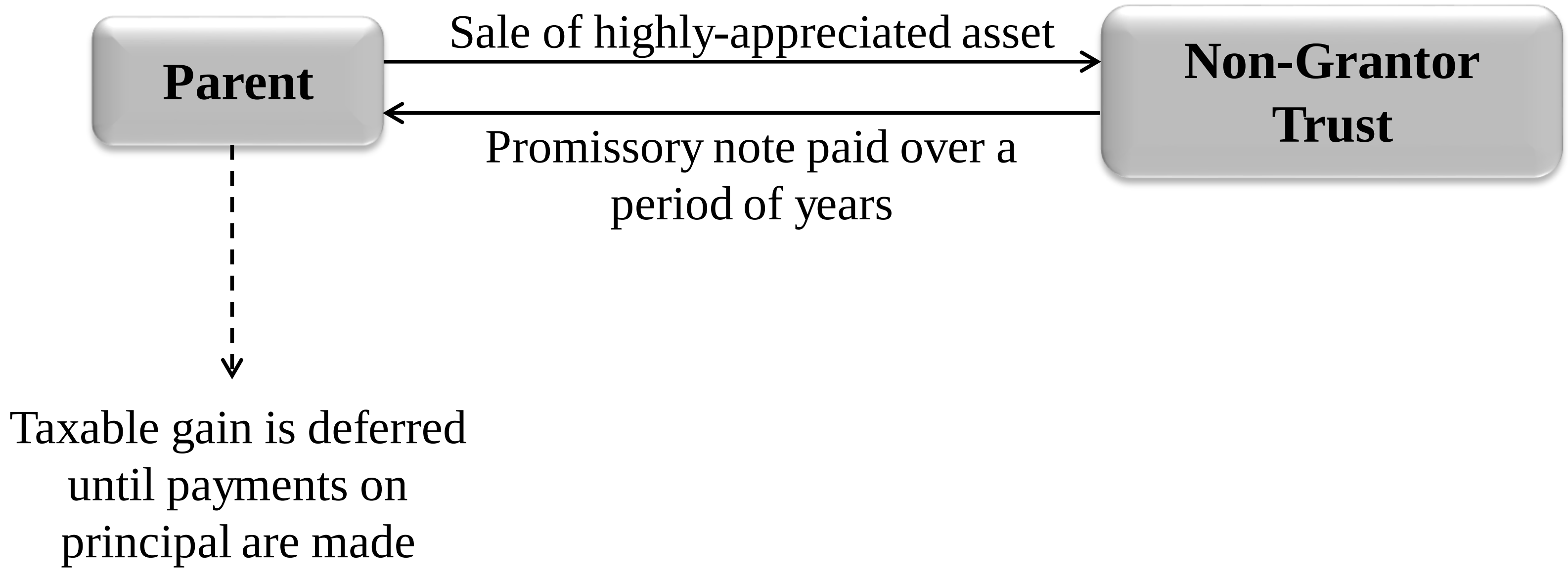
- Therefore, the original buyer must wait at least 2 years and one day to sell the asset to a third-party

(No realization of the original gain if the sale is at least two years and one day later)

Strategy

- Parent has an asset with a large capital gain
- Parent sells it to a nongrantor trust for the benefit of his or her children and takes back an installment note
- The trust receives a stepped-up basis in the asset
- Two years and one day later the trust sells the asset, recognizing little, if any, gain
- Trust makes payments to Parent who spreads the gain out over the period of the installment note

Strategy


Parent
Sale of highly-appreciated asset
Non-Grantor Trust
Promissory note paid over a period of years
Taxable gain is deferred until payments on principal are made

Benefits

- Income smoothing: Avoids the higher tax brackets & other thresholds (e.g. 1411/199A/461)

- Timing benefit: Children cash in the full appreciated value of the asset before most the gain is recognized by the parents.

Intra-Family Loans

Overview

- When interest rates are very low, intra-family loans can produce substantial tax-free transfers for families with estates subject to wealth transfer tax

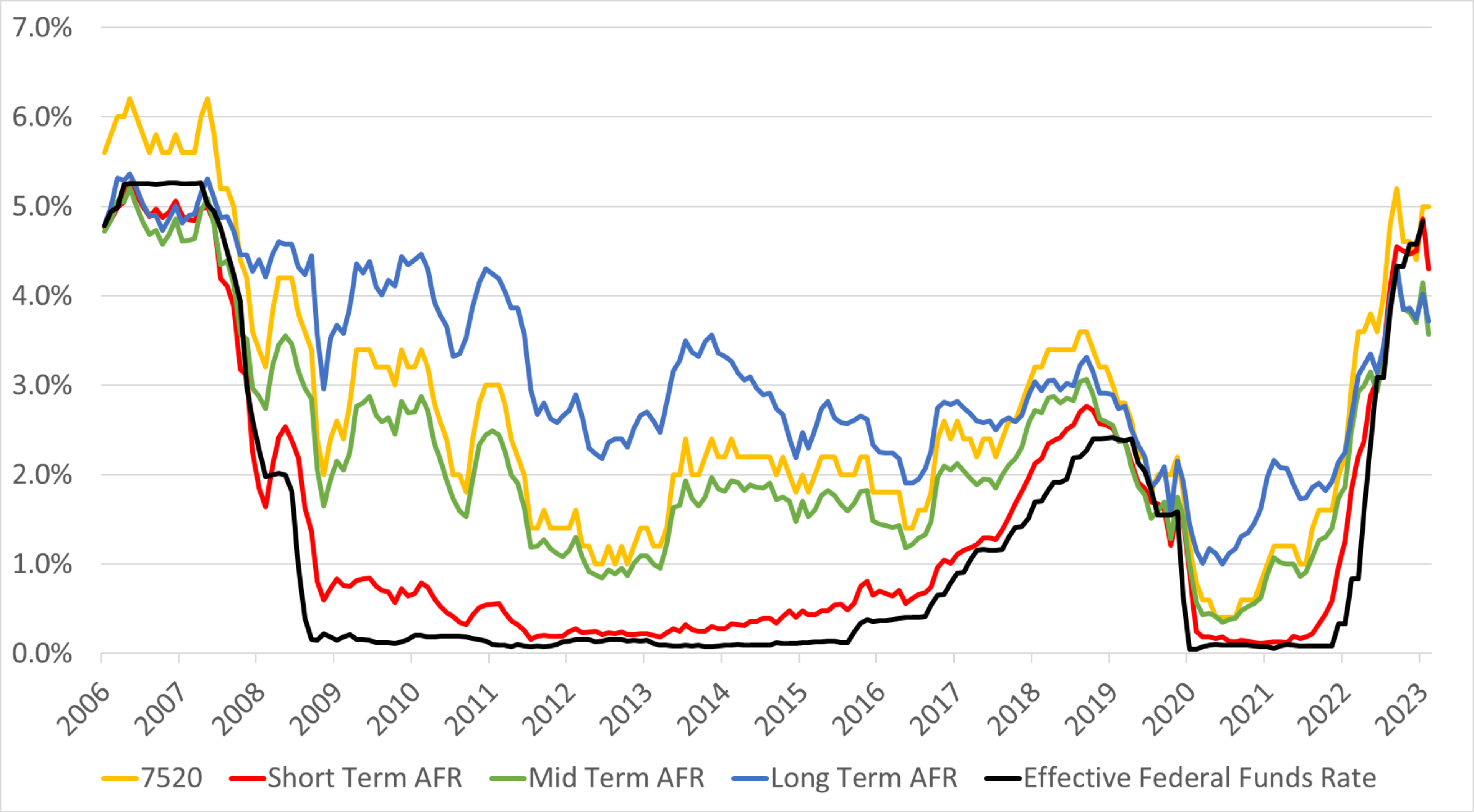
- Strategy: Simple rate arbitrage
  - Parents loan money to their children at a low interest rate
  - Children invest the borrowed money at a higher rate
  - The difference represents a tax-free increase in wealth for the children

Overview

- The minimum interest rate that must be charged on a note is the appropriate applicable federal rate (AFR) for the month of the transfer.

- These rates are low enough so that children can invest at a rate in excess of the interest rate on the note even without taking any appreciable risk.

Overview



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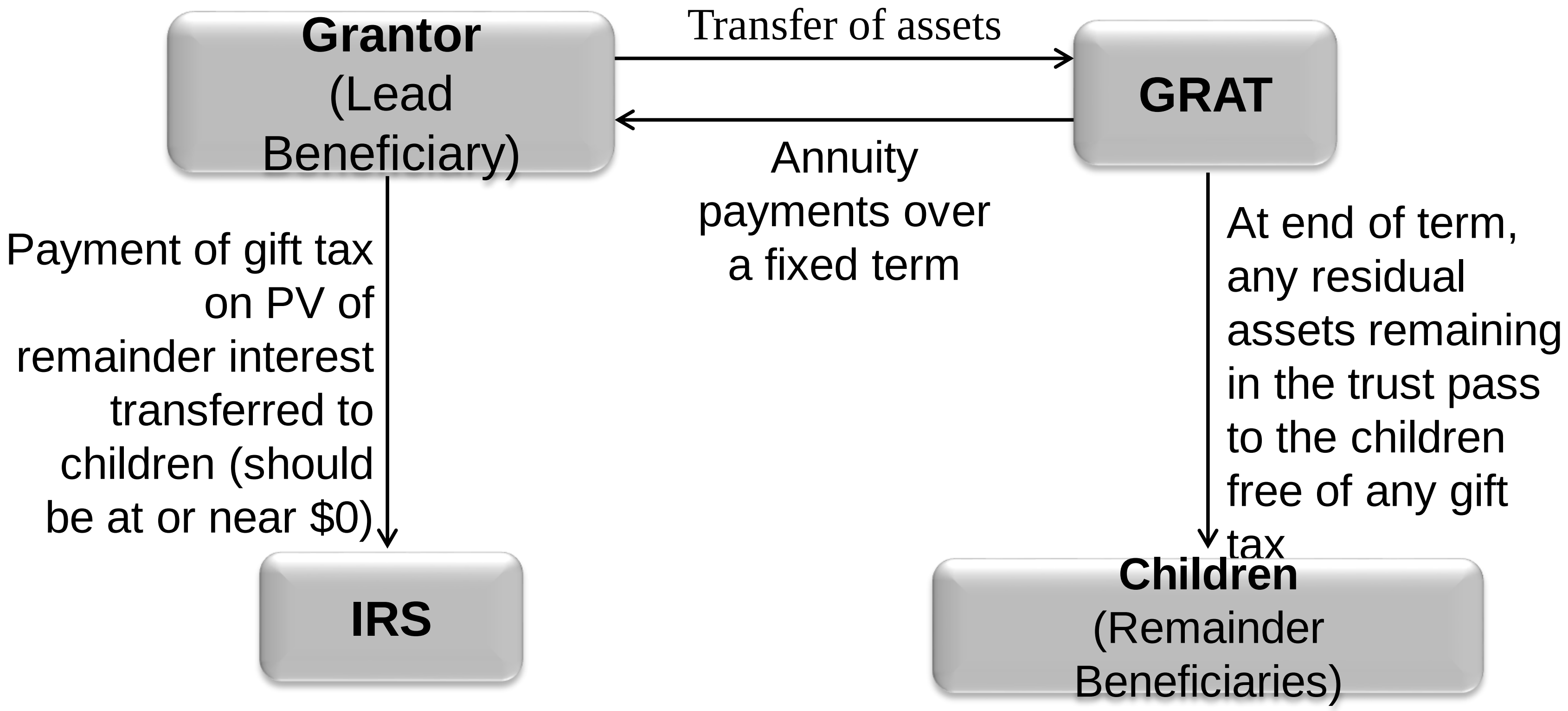
GRATs

Definition/Overview

- Split-interest trust where the grantor retains an annuity interest for a term, after which, any assets remaining pass to the remainder beneficiaries
- A GRAT is a type of trust that benefits the grantor’s future generations (e.g. children) without the imposition of estate and/or gift tax.
- To the extent that the actual rate of return on the trust’s assets exceeds the IRS’s rate (a.k.a. IRC Section 7520 rate), the “excess” is transferred to the trust’s beneficiaries free of any estate or gift tax.
- All income earned by the trust is taxed to grantor because the trust is “defective” for income tax purposes, thus allowing for a “tax-free” gift to the trust’s beneficiaries

Overview


Grantor
(Lead Beneficiary)
Transfer of assets
GRAT
Annuity payments over a fixed term
Payment of gift tax on PV of remainder interest transferred to children (should be at or near $0)
IRS
At end of term, any residual assets remaining in the trust pass to the children free of any gift tax
Children
(Remainder Beneficiaries)

Example: 10-Year GRAT

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $889,007	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (889,007)	$ 10,110,993
2	$ 10,110,993	$ 1,011,099	$ (889,007)	$ 10,233,086
3	$ 10,233,086	$ 1,023,309	$ (889,007)	$ 10,367,388
4	$ 10,367,388	$ 1,036,739	$ (889,007)	$ 10,515,120
5	$ 10,515,120	$ 1,051,512	$ (889,007)	$ 10,677,625
6	$ 10,677,625	$ 1,067,763	$ (889,007)	$ 10,856,381
7	$ 10,856,381	$ 1,085,638	$ (889,007)	$ 11,053,012
8	$ 11,053,012	$ 1,105,301	$ (889,007)	$ 11,269,307
9	$ 11,269,307	$ 1,126,931	$ (889,007)	$ 11,507,231
10	$ 11,507,231	$ 1,150,723	$ (889,007)	$ 11,768,947

Benefit: $11,768,947 Transferred to Beneficiaries Tax-Free

*Assumes a $7,000,000 (after valuation adjustments) initial contribution
**Assumes a 4.6% Section 7520 rate

GRATs
Why GRATs Work

Payment of trust income taxes by the grantor is tax free gift and diminishes grantor’s estate

Valuation adjustments on assets transferred “Disappearing value”

Difference between actual rate of return and IRC §7520 rate if it can be achieved makes leveraging strategy work

Advantages

- Annuity payments provide income stream to the grantor
- Ability to make gifts of substantial amounts of property tax-free
- Grantor pays income tax on trust income, leaving more assets in the GRAT for remainder beneficiaries
- Reduces the taxable estate of the grantor
- Valuation adjustments increase effectiveness of sale for estate tax purposes

Disadvantages

- If the grantor dies before the end of the GRAT term, a significant portion of the assets held in the GRAT are included in the grantor’s estate
- The remainder beneficiaries will have the same basis in the property transferred to the GRAT as the grantor had at the time the property was transferred (no step-up in cost basis)
- Risk that rate of return will not exceed interest rate resulting in no assets being transferred to remainder beneficiaries

Funding

- “Good” Assets
  - Assets with significant growth potential
  - Assets with good cash flow
  - Discountable assets (i.e. S-Corps, LLCs, partnerships)
- “Bad” Assets
  - Raw land
  - Personal property
  - Low growth assets
  - Assets with inadequate cash flow

Other Features/Enhancements

- “Indexed” GRATs
  - GRATs where the current annual payment increases by 20% over the prior year’s payment
  - Allows for growth to stay in the GRAT longer
- “Staggered” GRATs
  - Multiple GRATs with different terms
  - Hedges against the risk of premature death and the risk of interest rates decreasing
- “Rolling” GRATs
  - GRATs which are funded with other GRAT payments
  - Hedges against the risk of premature death and the risk of rate of return underperformance

Dynasty Trusts

Overview

- Takes advantage of how the generation-skipping transfer tax (GSTT) is applied by passing assets down through successive generations of family

- Other benefits may include: creditor protection, divorce protection, and spendthrift protection

Strategy

- Taxpayer uses the gift and GSTT exclusion amount to avoid tax on the initial transfer to the trust
- No transfer tax is payable at any generation of beneficiaries thereafter because the beneficiaries have only discretionary interests that are not includable in their estates when they die
- Thus, for trusts created in some states, a one-time use of the gift and GSTT exemption eliminates transfer tax for a family forever

Overview

Advantages:

- Creditor Protection
- Divorce Protection
- Estate Tax Protection
- Direct Descendent Protection
- Spendthrift Protection
- Consolidation of Capital

Grantor → Gift* → **Dynasty Trust**

No transfer tax paid

Discretionary Distributions to Children for Life

No transfer tax paid

Discretionary Distributions to Grandchildren for Life

No transfer tax paid

Discretionary Distributions to Great-Grandchildren for life

No transfer tax paid

Future Generations

*Gift should take advantage of any remaining lifetime gift exclusion and lifetime GST exclusion

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Tax Savings From Avoiding Estate Tax

	5% Growth	7% Growth	9% Growth
Value of Trust in 20 years	$ 13,266,489	$ 19,348,422	$ 28,022,054
Estate Tax Savings @ 40%	$ 5,306,595	$ 7,739,369	$ 11,208,822
Value of Trust in 40 years	$ 35,199,944	$ 74,872,289	$ 74,872,289
Estate Tax Savings @ 40%	$ 14,079,977	$ 29,948,916	$ 29,948,916
Value of Trust in 60 years	$ 93,395,929	$ 289,732,134	$ 880,156,460
Estate Tax Savings @ 40%	$ 37,358,372	$ 115,892,854	$ 352,062,584
Value of Trust in 80 years	$ 247,807,205	$ 1,121,171,938	$ 4,932,758,341
Estate Tax Savings @ 40%	$ 99,122,882	$ 448,468,775	$ 1,973,103,336

Initial “investment” of $5,000,000

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Advantages

- Takes maximum advantage of the $12.92M lifetime gift tax exemption
- Takes maximum advantage of the $12.92M GSTT exemption
- Appreciation of assets will be free from estate tax
- Provides a layer of asset protection from the beneficiaries' creditors
- No estate/gift/GST tax will be paid at the death of the grantor's descendants
- Future trustees can be given the discretion to make distributions as appropriate, given the circumstances that exist at the time the distributions are made
- Grantor can use the trust to positively affect future behavior

IDGT Sale

Definition

An IDGT is a type of dynasty trust where all income earned by the trust is taxed to the grantor because the trust is “defective” for income tax purposes, thus allowing for a tax-free gift to the trust’s beneficiaries.

Overview

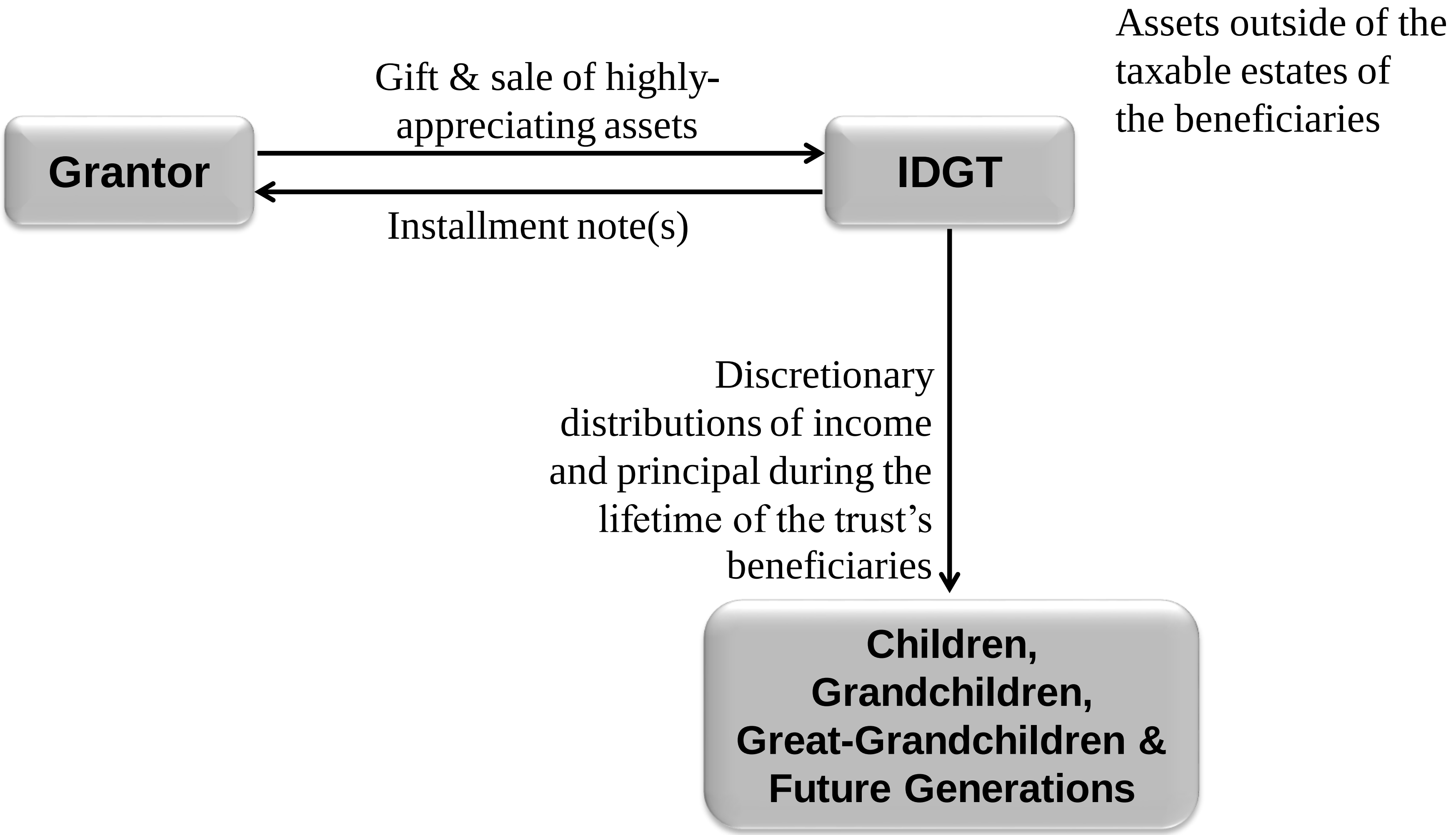
- A type of transaction whereby a grantor sells a highly-appreciating asset to an IDGT in exchange for an installment note.
- However, the grantor should make an initial gift (at least 10% of the total transfer value) to the trust so that it has sufficient capital to make its payments to the grantor.
- To the extent that the growth rate on the assets sold to the IDGT is greater than the interest rate on the installment note taken back by the grantor, the "excess" is passed on to the trust beneficiaries free of any gift, estate and/or GST tax.

Overview

- No capital gains tax is due on the installment sale to the trust because the trust is “defective” for income tax purposes.

- Interest income on installment note is not taxable to the grantor because the trust is “defective” for income tax purposes.

Overview


Assets outside of the taxable estates of the beneficiaries
Gift & sale of highly-appreciating assets
Grantor
IDGT
Installment note(s)
Discretionary distributions of income and principal during the lifetime of the trust’s beneficiaries
Children, Grandchildren, Great-Grandchildren & Future Generations

AFRs – *January 2023*

Time Period	Rate
Short-term AFR (3 years or less)	4.50%
Mid-term AFR (over 3 years, up to 9 years)	3.85%
Long-term AFR (over 9 years)	3.84%

IDGT Sale

Why an IDGT Sale Works

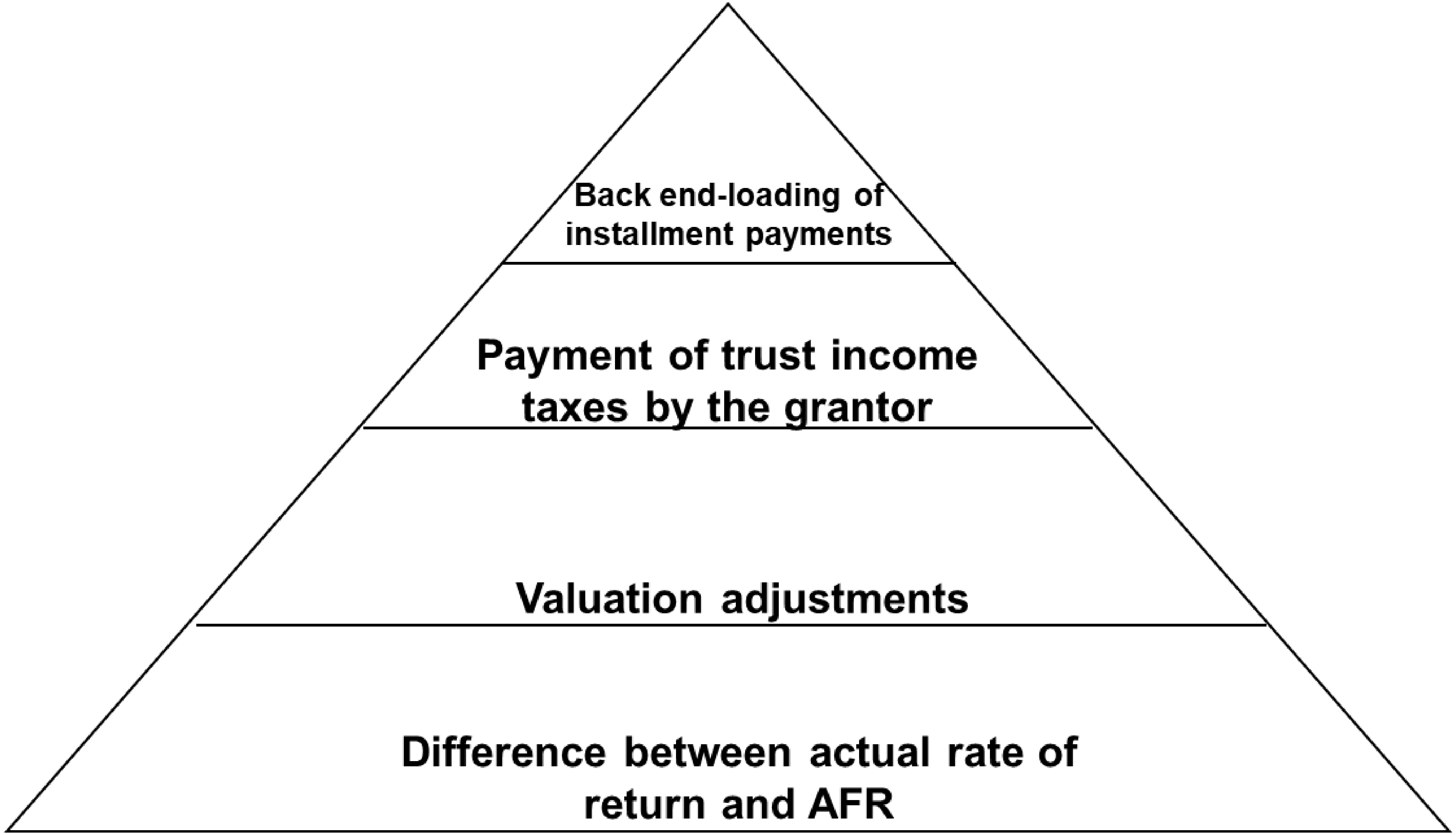
Long-Term AFR Rate 3.84%

Year	Beginning Balance	Taxable Income 10.00%	Annual Payment	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (268,800)	$ 10,731,200
2	$ 10,731,200	$ 1,073,120	$ (268,800)	$ 11,535,520
3	$ 11,535,520	$ 1,153,552	$ (268,800)	$ 12,420,272
4	$ 12,420,272	$ 1,242,027	$ (268,800)	$ 13,393,499
5	$ 13,393,499	$ 1,339,350	$ (268,800)	$ 14,464,049
6	$ 14,464,049	$ 1,446,405	$ (268,800)	$ 15,641,654
7	$ 15,641,654	$ 1,564,165	$ (268,800)	$ 16,937,019
8	$ 16,937,019	$ 1,693,702	$ (268,800)	$ 18,361,921
9	$ 18,361,921	$ 1,836,192	$ (268,800)	$ 19,929,314
10	$ 19,929,314	$ 1,992,931	$ (7,268,800)	$ 14,653,445

BENEFIT: $14,653,445 Transferred to Beneficiaries Tax-Free

* Assuming a $7,000,000 (after valuation adjustments) interest only, balloon payment feature installment note with a 3.84% annual interest rate (long-term AFR)

Overview


Back end-loading of installment payments
Payment of trust income taxes by the grantor
Valuation adjustments
Difference between actual rate of return and AFR

Advantages

- Freezes value of appreciation on assets sold in the grantor's taxable estate at the low interest rate on the installment note payable
- No capital gains tax due on installment sale
- Interest income on installment note is not taxable to the grantor
- Grantor pays income tax on trust income, leaving more assets in the IDGT for remainder beneficiaries
- Valuation adjustments increase effectiveness of sale for estate tax purposes

Disadvantages

- Estate inclusion of note if grantor dies during term of installment note
- No step-up in basis at grantor’s death
- Trust income taxable to grantor during his/her life could cause a cash flow problem if there is not sufficient income earned by the grantor
- Possible gift and estate tax exposure if insufficient assets are used to fund the trust
- Possible taxable gift for amount of loan
- Possible taxable estate inclusion under *Karmazin* (retained life estate)

Spousal Limited Access Trusts

Overview

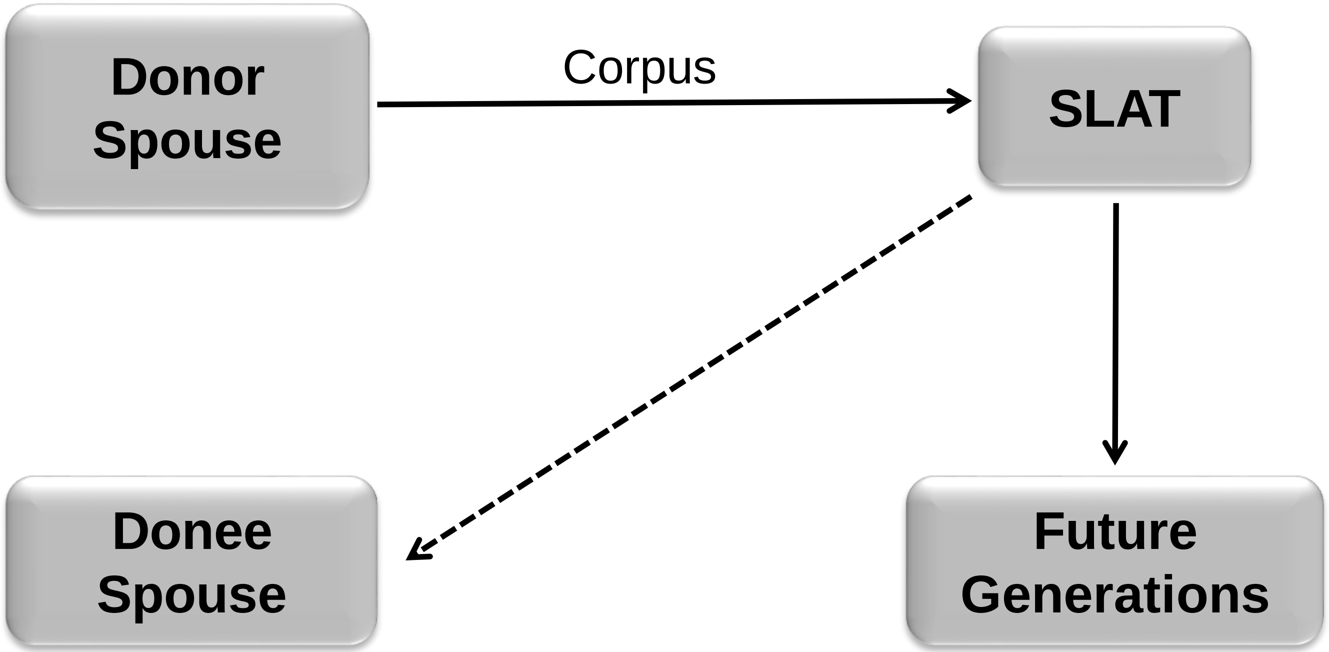
- A SLAT is a type of domestic asset protection trust (DAPT) in which each spouse creates a trust for the benefit of the other spouse (with the remainder interest passing to his/her heirs).

- The purpose of this trust is to provide a source of cash flow to the spouse-beneficiary while keeping the assets secure from creditors and other legal claims.

Overview

- Takes advantage of the high applicable exclusion amount
- Removes substantial amounts of appreciation from the estate
- Donor spouse indirectly retains the ability to access the funds if necessary through distributions to the spouse

Overview



Caveat

- Caveat: The Reciprocal Trust Doctrine
- Might apply if both spouses set up a SLAT for the benefit of the other
- Make the SLATs sufficiently different from each other in order to avoid application of the doctrine

Portability

Portability Basics

Portability allows the executor to either utilize the decedent’s estate tax exclusion amount ($12,920,000 in 2023) or to transfer it to the decedent’s surviving spouse.

*However, the new law does not allow the decedent to transfer his/her unused GST tax exemption to the surviving spouse.

See 26 USC 2010(c)(4).

Portability Basics

<u>Key Issues</u>

The election to transfer the unused estate tax exemption amount ***<u>must be made on a timely-filed estate tax return</u>***

- The IRS original position was that no election can be made on a late-filed return
- Since then, streamlined procedures for relief have been made available

Mathematics of Portability

"It's a balancing Act"

Estate
Tax

Income
Tax

Mathematics of Portability

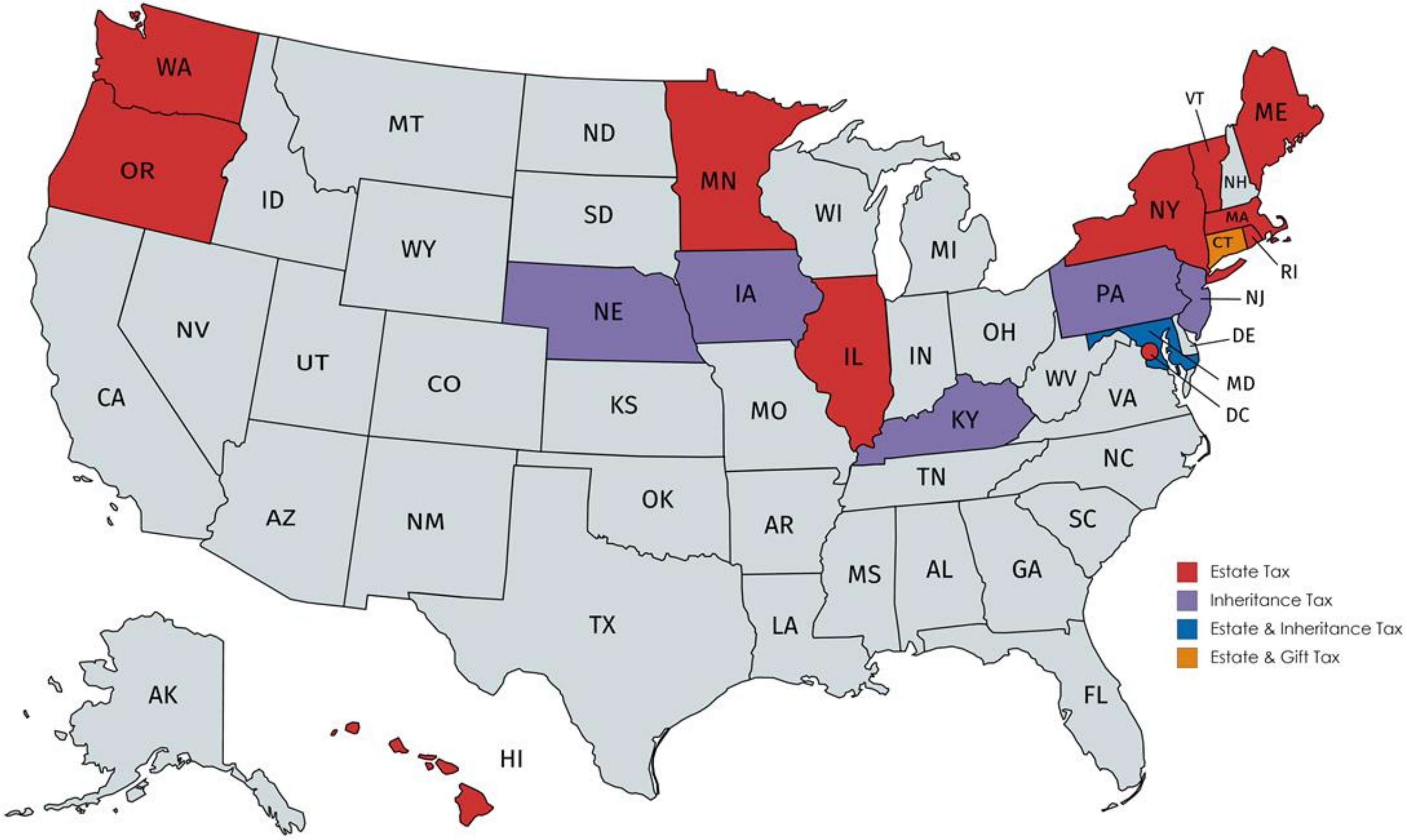
Core Concepts – Saving Income Tax

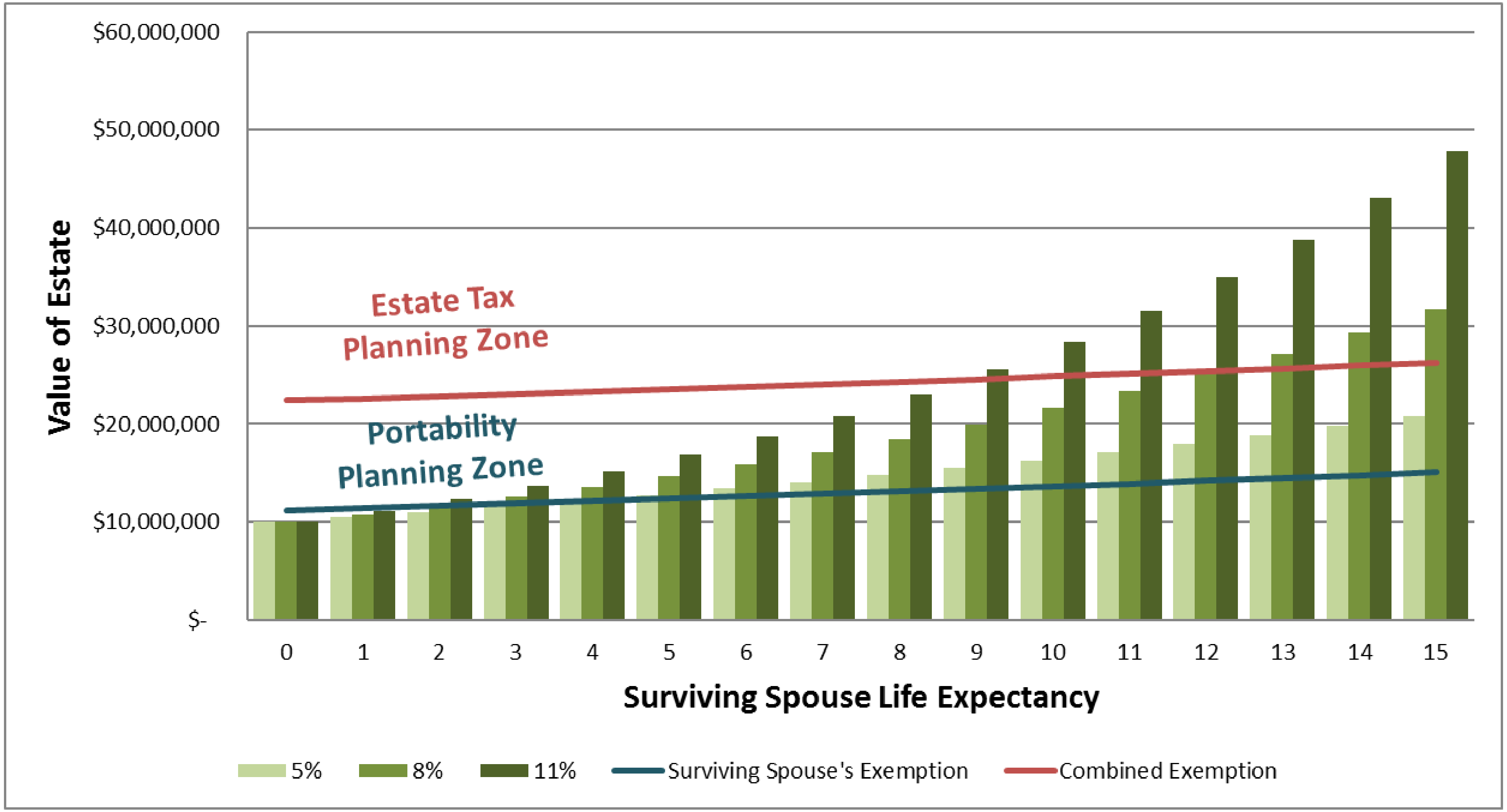
- Carryover basis – IRC §1015
- Step-up in basis – IRC §1014
- Federal Capital Gains Tax
- State Capital Gains Tax
- Taxation of Trusts and Estates

Core Concepts – Saving Transfer Tax

- Estate Tax: 40%
- GST Tax: 40%
- Gift Tax: 40%
- State Estate/Inheritance Tax: 0% - 20%
- State Gift Tax: 0% - 12%

Transfer Taxes by State



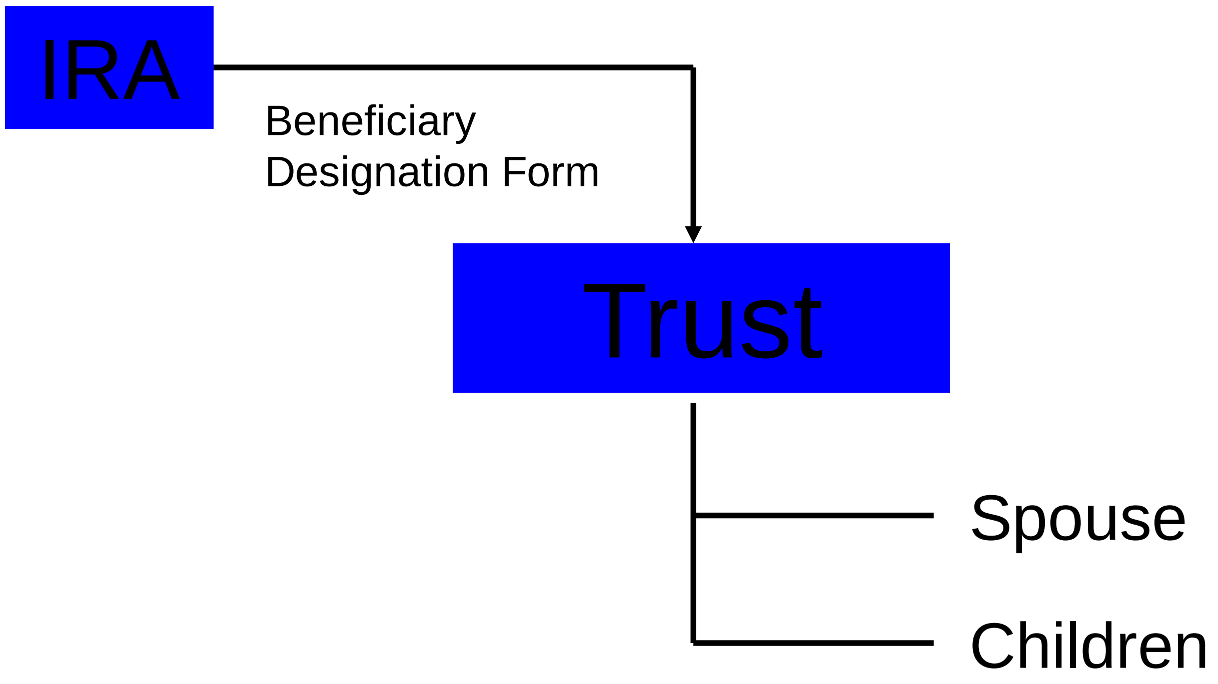


Consider a couple with a combined estate of $10,000,000 and note the effect of a long life expectancy and or a high rate of return.

IRAs to Trust

Trust Named as IRA Beneficiary

An IRA Can Be Payable to a Trust



Advantages of Naming a Trust

- Greater assurance distributions will be prudent from a tax perspective
- Greater ability to vary and target distributions by the beneficiary’s situation
- Greater assurance the beneficiaries will be named correctly
- Creditor protection
- Dead hand control
- Spendthrift protection
- Divorce protection

Thank You

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