



# **The Top 25 Best Planning Ideas**

## **Tulsa Estate Planning Forum**

### **Annual Meeting**

*Presented by*

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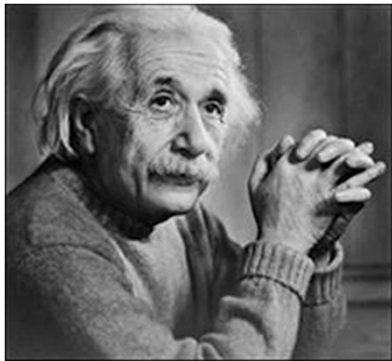
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# The Top 25 Best Planning Ideas

## Section 1: Bracket Management Strategies

1. Bracket Management
2. Capital Gain Harvesting
3. Harvesting Capital Losses
4. Trusts as S Corporation Shareholders: ESBT vs. QSST



## Section 2: Income Smoothing Strategies

5. Substantial Sale CRT
6. Retirement CRT
7. Roth IRA Conversions and IRA Relocation
8. Oil & Gas Investments
9. Two-Year Installment Sales
10. Nonqualified Tax Deferred Annuities
11. Borrowing from Life Insurance

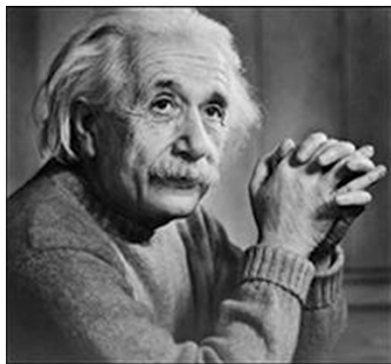
# The Top 25 Best Planning Ideas

## Section 3: Income Shifting Strategies

12. Income Shifting CRT
13. Family Limited Partnerships

## Section 4: Strategies for Reducing Taxable Income

14. Tax-Aware Investing
15. Nevada Incomplete Gift, Non-Grantor (NING) Trusts
16. Captive Insurance Companies



## Section 5: Specific Strategies for Reducing NIIT

17. Inter Vivos CLAT
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19. Choice of Filing Status

## Section 6: Wealth Transfer Strategies

20. Intra-Family Loans
21. GRAT
22. Dynasty Trust
23. IDGT Sale
24. Domestic Asset Protection Trusts
25. Spousal Limited Access Trust

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# Section 1:

## Bracket Management Strategies

1. Bracket Management
2. Capital Gain Harvesting
3. Harvesting Capital Losses
4. Trusts as S Corporation Shareholders:  
ESBT vs. QSST

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# #1 Bracket Management

## *Time Frame Shift*

- 1980-2002: 3-5 year horizon
- 2002-2010: EGTRRA Decade
- 2010-2012: Time of irresolution
- 2013-Forward: 5-10 year horizon

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# #1 Bracket Management

## *2014 Ordinary Income Rates*

- 10%, 15%, 25% and 28% rates from Bush Administration tax cuts made permanent
- 33% and 35% rates made permanent up to certain threshold levels—

|  |           |
|--|-----------|
| Single taxpayers                           | \$406,750 |
| Head of households                         | \$432,200 |
| Married filing jointly or surviving spouse | \$457,600 |
| Married filing separately                  | \$228,800 |

- Amounts of income above these threshold levels taxed at 39.6%
  - If it is NII, then it will be taxed at 43.4%
- Threshold amounts adjusted for inflation

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# #1 Bracket Management

## *2014 Long-Term Capital Gains & Dividend Rates*

- Tax rate increases to 20% for taxpayers with income above the threshold amounts listed on the previous slide
  - As these taxpayers will be above the threshold amounts for the 3.8% NIIT, their capital gain rate will actually be 23.8%
- Maximum rate stays at 15% for taxpayers with lower incomes
- Qualified dividend treatment is made permanent
- 0% Rate if you are in the 10% or 15% bracket

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# #1 Bracket Management

## *Phase-Out of Personal Exemptions & Itemized Deductions*

- Phase-out of personal exemptions (PEP) and limitations on itemized deductions (Pease) as income rises above the following threshold amounts--

|  |           |
|--|-----------|
| Single taxpayers                           | \$254,200 |
| Head of households                         | \$279,650 |
| Married filing jointly or surviving spouse | \$305,050 |
| Married filing separately                  | \$152,525 |

- Amounts will be indexed for inflation



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# #1 Bracket Management

## *Phase-Out of Personal Exemptions (PEP)*

- PEP reduces personal exemption by 2% for—
  - every \$2,500 of income above the threshold amount for single taxpayers
  - every \$1,250 of income above the threshold amount for married taxpayers filing separately

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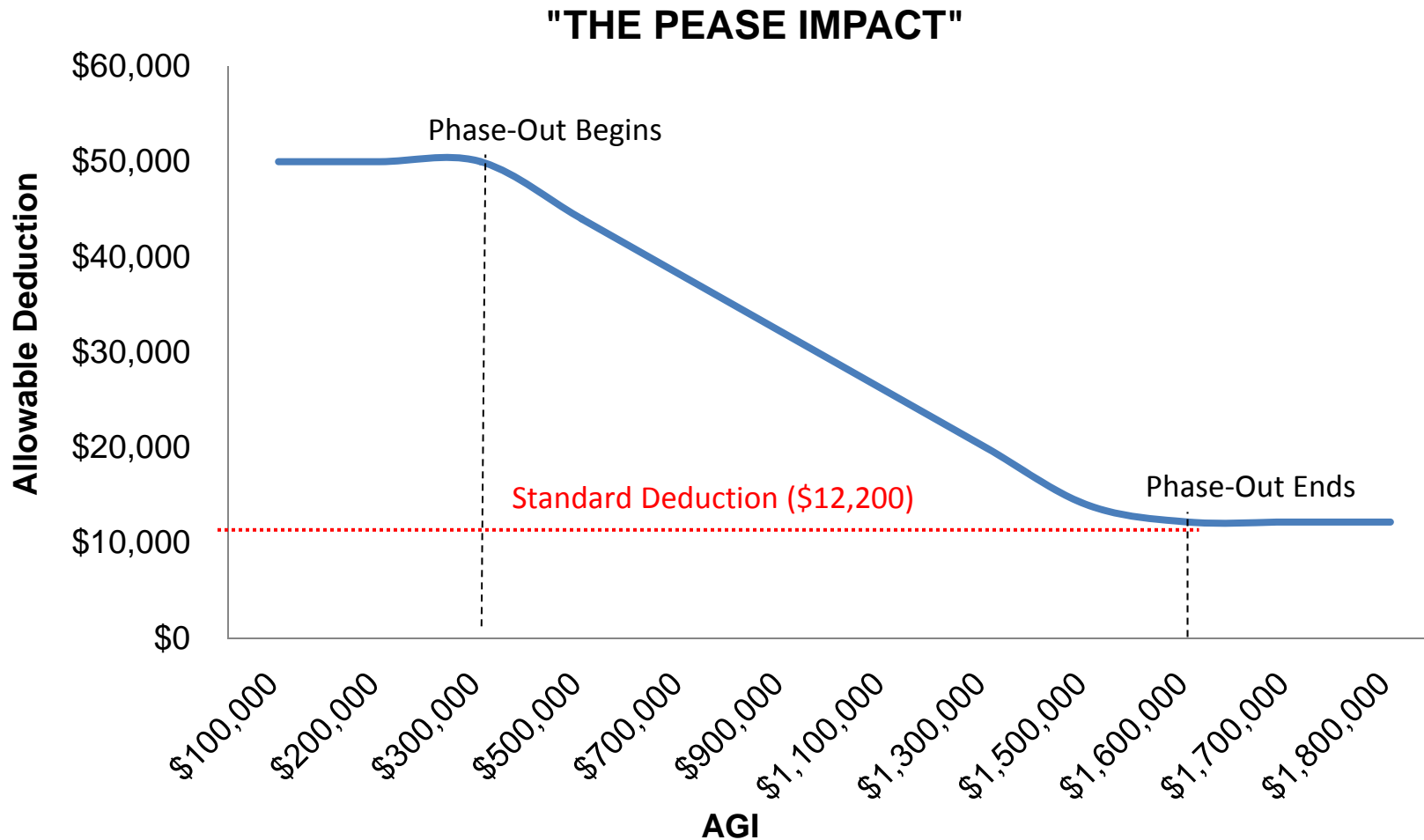
# #1 Bracket Management

## *Phase-Out of Itemized Deductions (Pease)*

- Pease cuts itemized deductions by 3% of AGI above the threshold amounts up to a maximum of 80%
- Deductions not included:
  - Investment Interest
  - Medical Expenses
  - Casualty, theft and wagering losses

# #1 Bracket Management

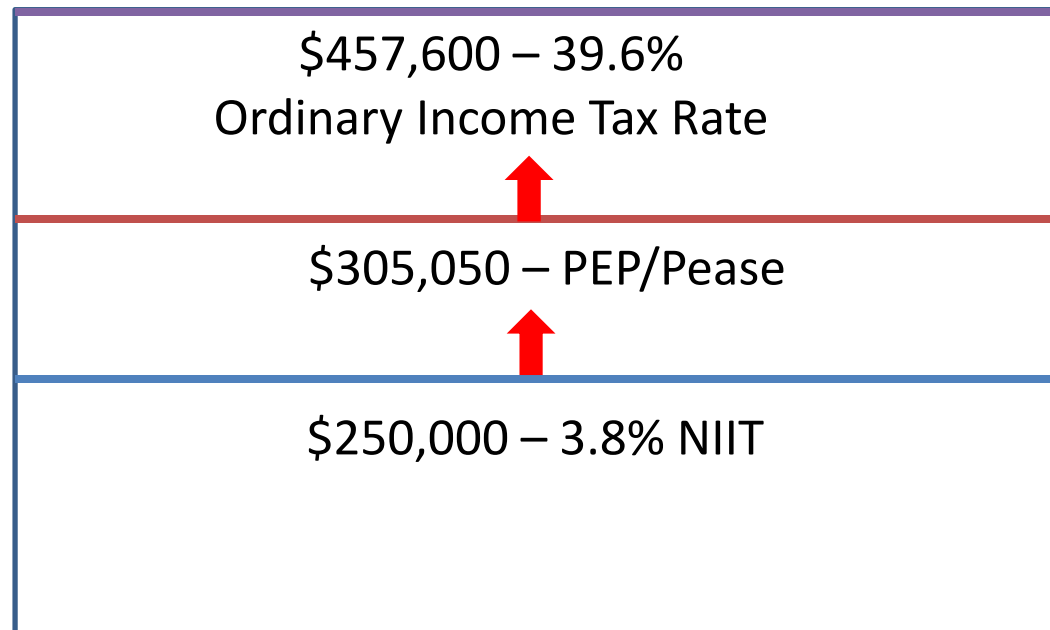
## *Phase-Out of Itemized Deductions (Pease)*



# #1 Bracket Management

*Recap*

**“Flying below the radar”**



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# #1 Bracket Management

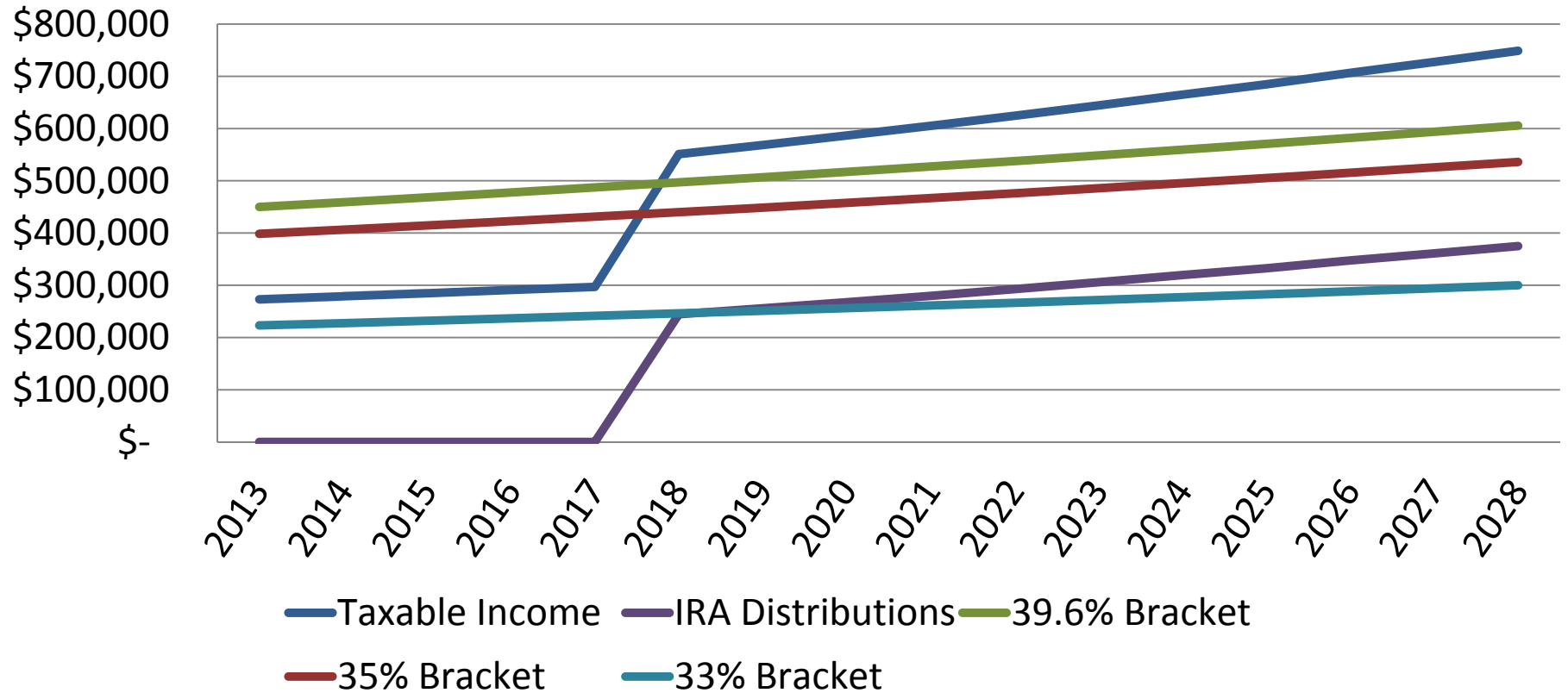
## *Key Management Issues*

- Capital Gain Rates
- Income Tax Rates
- Ordinary Income should at least equal Itemized Deductions plus exemptions
- Tax liability should equal tax credits available

# #1 Bracket Management

## *Poor Bracket Management Scenario*

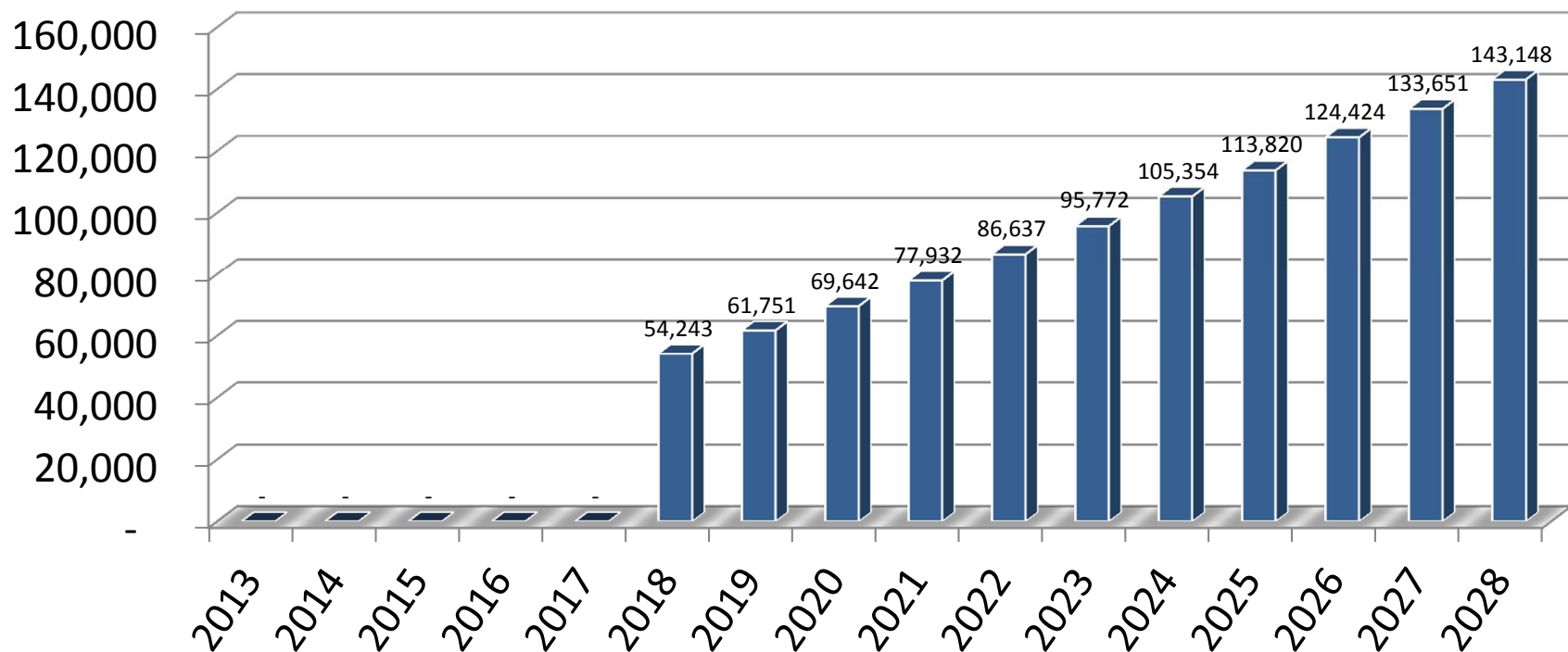
### Taxable Income and RMD



# #1 Bracket Management

## *Poor Bracket Management Scenario*

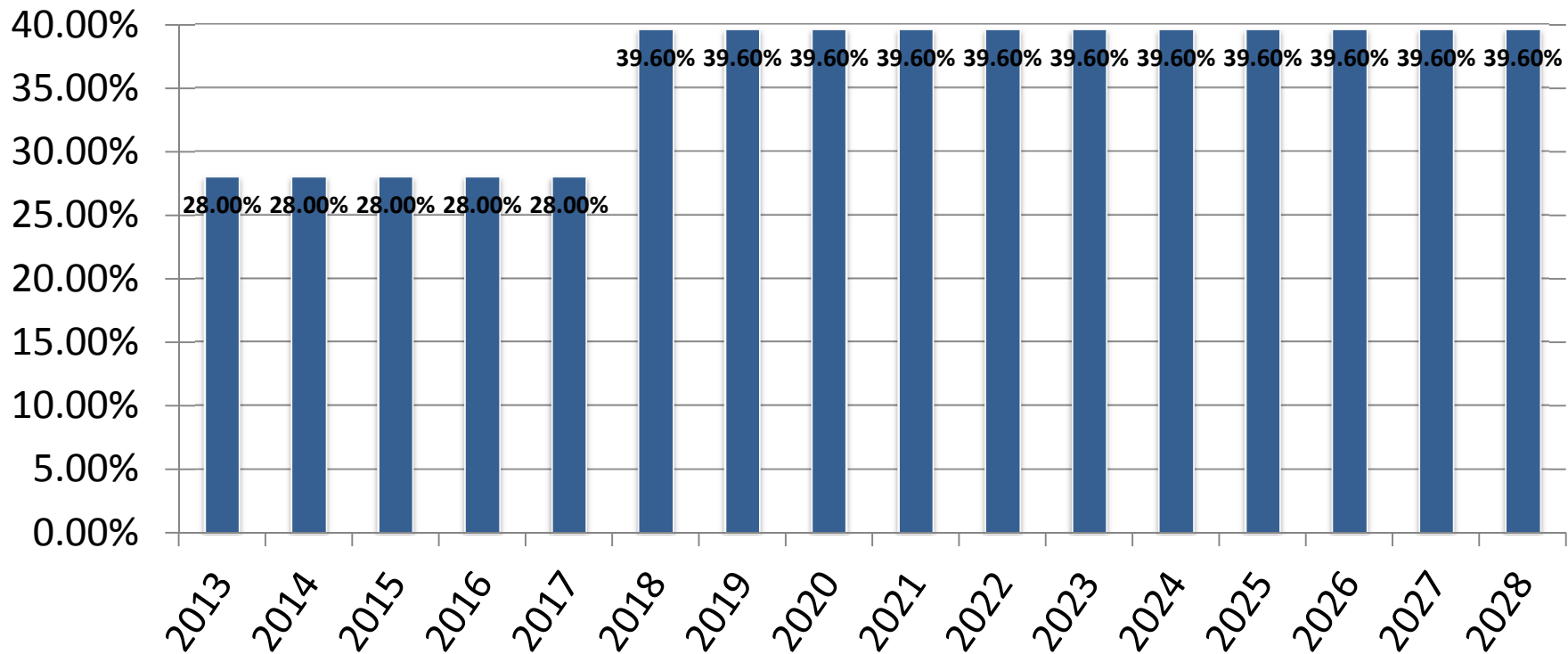
### Amount over 39.6% Tax Bracket



# #1 Bracket Management

## *Poor Bracket Management Scenario*

Income Tax Rate

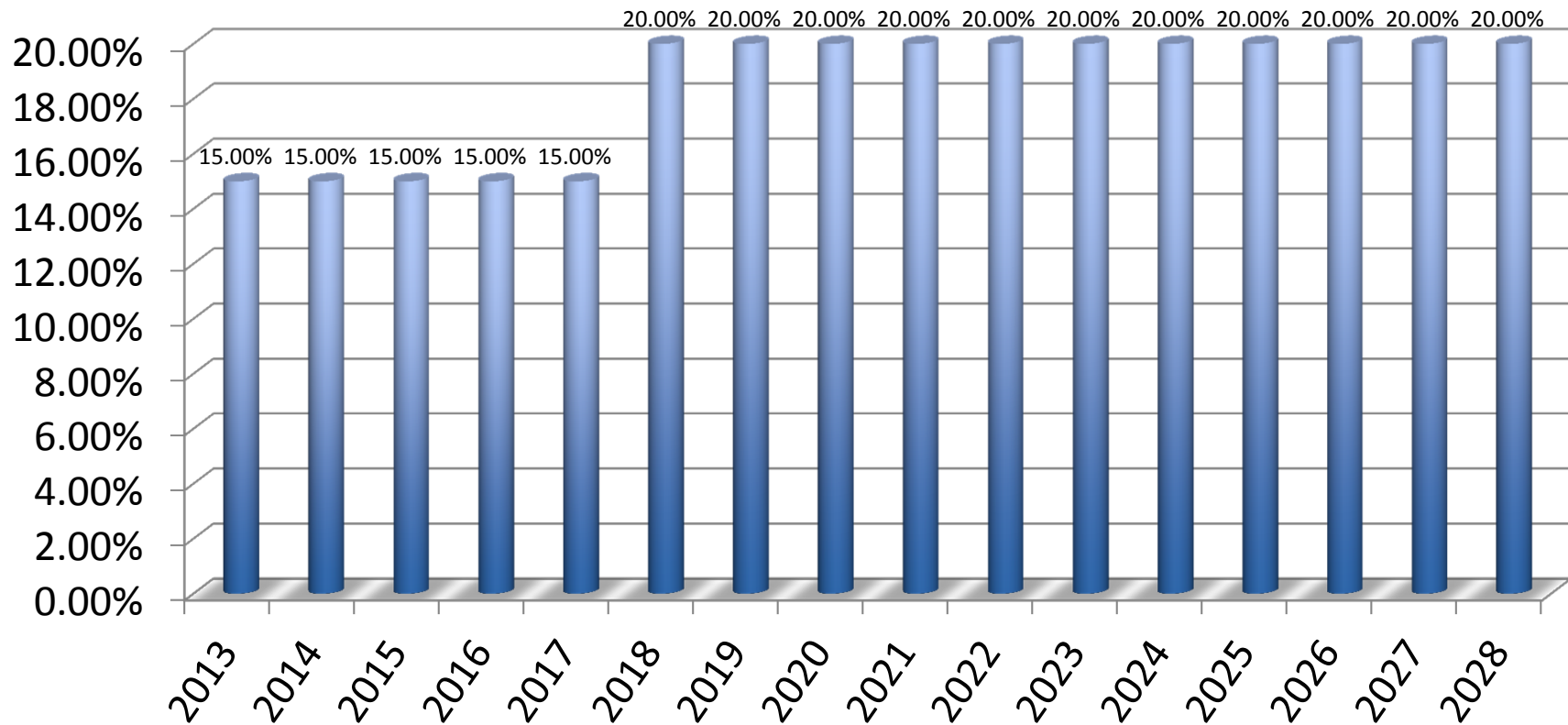




# #1 Bracket Management

## *Poor Bracket Management Scenario*

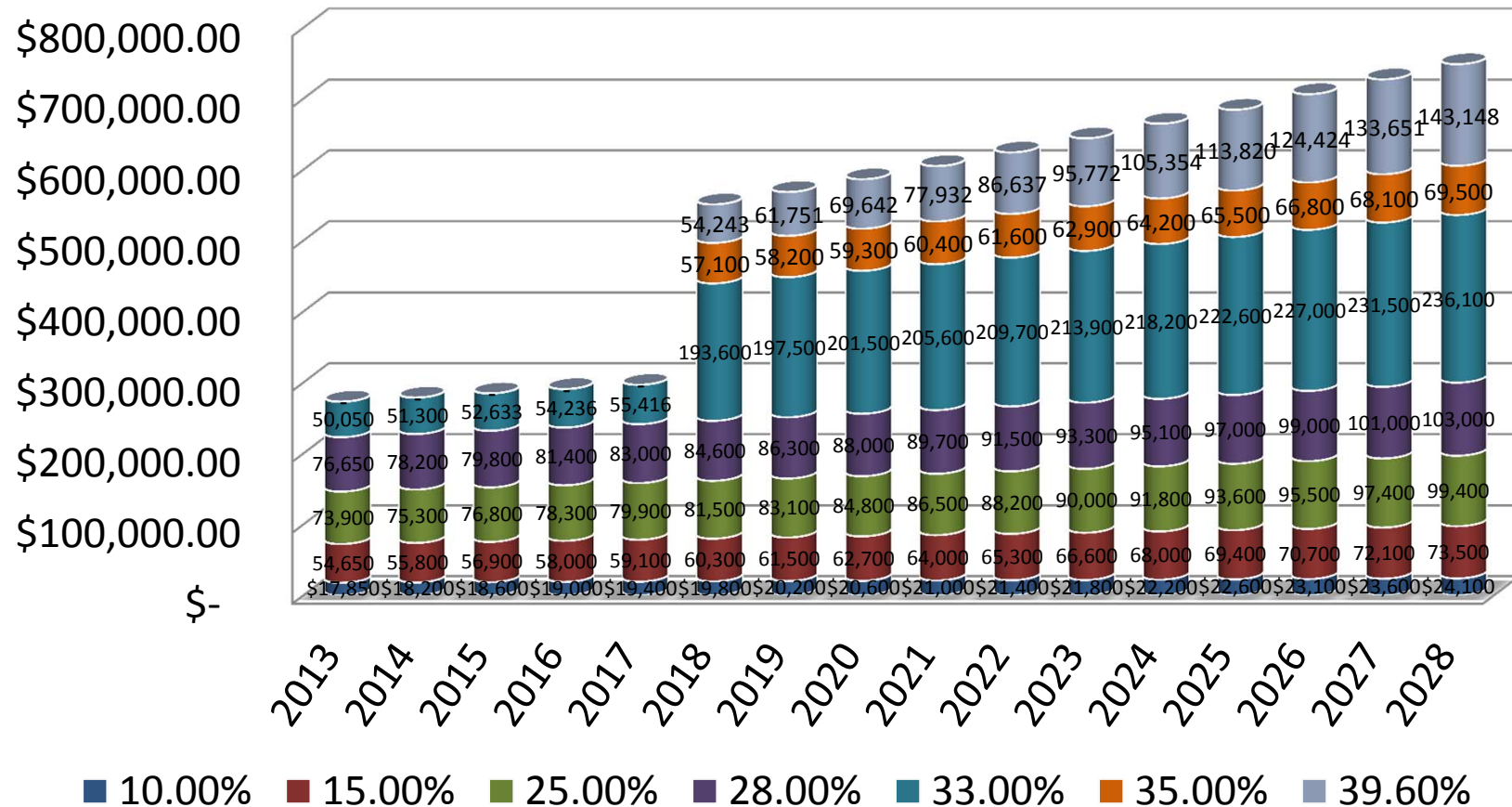
### Capital Gains Tax Rate



# #1 Bracket Management

## Poor Bracket Management Scenario

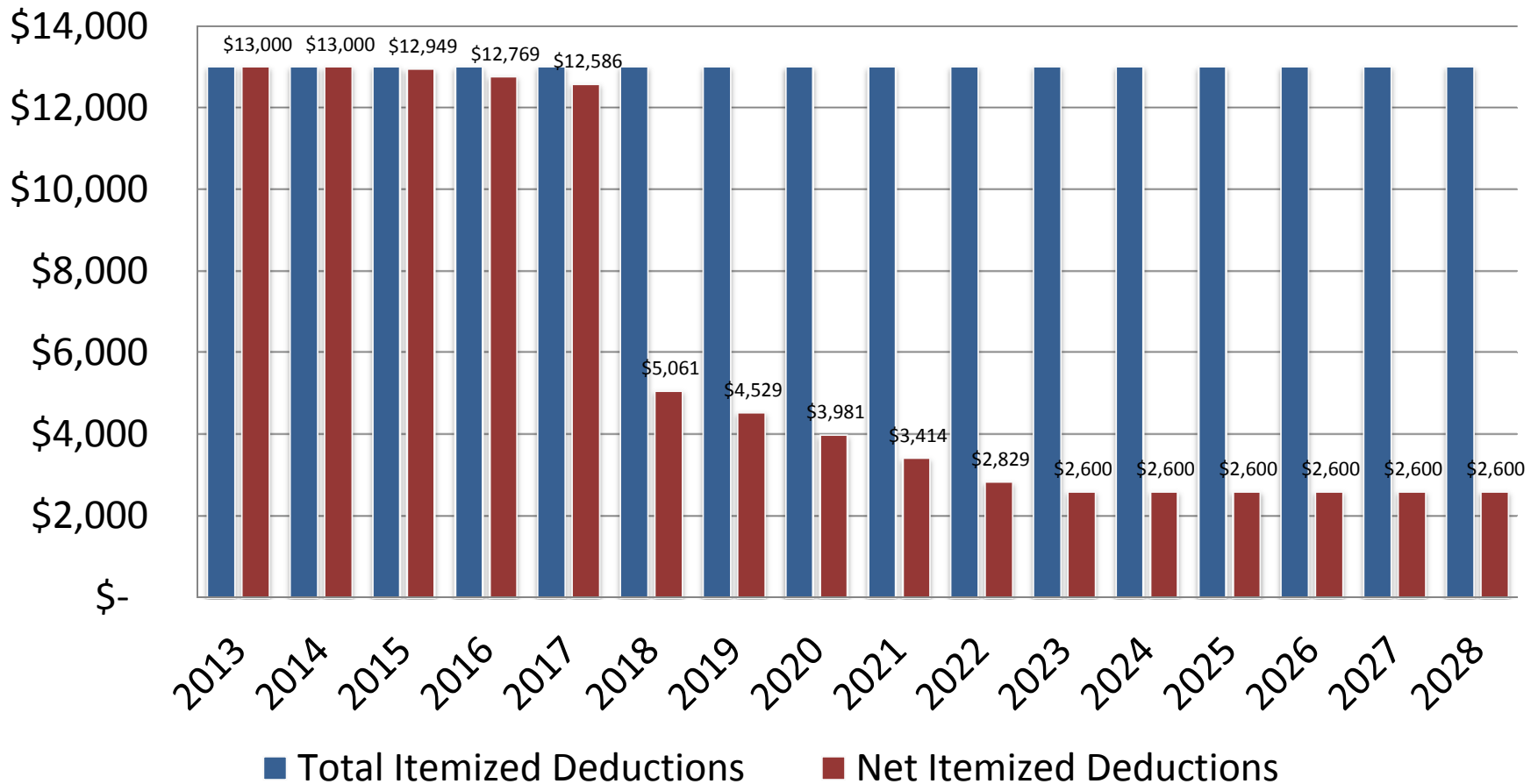
### Taxable Income per Bracket



# #1 Bracket Management

## *Poor Bracket Management Scenario*

### Itemized Deductions



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# #1 Bracket Management

## *Bracket Management Example*

- 5 Year Projection
- In 2013:
  - \$150,000 Wages
  - \$50,000 Long-Term Capital Gains
  - \$20,000 Itemized Deductions
- In 2015:
  - RMDs on a \$5,000,000 IRA start
- 2% Inflation Rate

# #1 Bracket Management

## *Bracket Management Example*

| <b>INCOME</b>                      | <b>2013</b>       | <b>2014</b>       | <b>2015</b>       | <b>2016</b>       | <b>2017</b>       |
|------------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Wages                              | \$ 150,000        | \$ 153,000        | \$ 156,100        | \$ 159,200        | \$ 162,400        |
| Long-Term Capital Gains            | 50,000            | 51,000            | 52,000            | 53,000            | 54,100            |
| IRA Distributions                  | -                 | -                 | 211,245           | 220,971           | 231,113           |
| Subtotal                           | \$ 200,000        | \$ 204,000        | \$ 419,345        | \$ 433,171        | \$ 447,613        |
| <b>Adjusted Gross Income (AGI)</b> | <b>\$ 200,000</b> | <b>\$ 204,000</b> | <b>\$ 419,345</b> | <b>\$ 433,171</b> | <b>\$ 447,613</b> |
| Total Deduction Taken              | \$ 20,000         | \$ 20,000         | \$ 16,420         | \$ 16,005         | \$ 15,572         |
| Net Personal Exemptions            | 7,800             | 8,000             | 328               | -                 | -                 |
| <b>Taxable Income</b>              | <b>\$ 172,200</b> | <b>\$ 176,000</b> | <b>\$ 402,598</b> | <b>\$ 417,166</b> | <b>\$ 432,041</b> |
| Regular Income Tax                 | \$ 29,908         | \$ 30,590         | \$ 98,843         | \$ 102,981        | \$ 107,194        |
| AMT                                | -                 | -                 | 3,648             | 3,743             | 3,966             |
| 3.8% NIIT                          | -                 | -                 | 1,976             | 2,014             | 2,056             |
| <b>TOTAL INCOME TAX</b>            | <b>\$ 29,908</b>  | <b>\$ 30,590</b>  | <b>\$ 104,467</b> | <b>\$ 108,738</b> | <b>\$ 113,215</b> |

# #1 Bracket Management

## *Bracket Management Example*

|  | 2013          | 2014          | 2015          | 2016          | 2017          |
|--|---------------|---------------|---------------|---------------|---------------|
| MARGINAL INCOME TAX RATE                 | 25.00%        | 25.00%        | 33.00%        | 33.00%        | 33.00%        |
| MARGINAL CAPITAL GAINS RATE              | 15.00%        | 15.00%        | 15.00%        | 15.00%        | 15.00%        |
| CURRENTLY SUBJECT TO NIIT                | No            | No            | Yes           | Yes           | Yes           |
| MARGINAL INCOME TAX RATE if NIIT APPLIES | 25.00%        | 25.00%        | 36.80%        | 36.80%        | 36.80%        |
| MARGINAL CAPITAL GAIN TAX RATE WITH NIIT | 15.00%        | 15.00%        | 18.80%        | 18.80%        | 18.80%        |
| <b>AVERAGE RATE</b>                      | <b>14.95%</b> | <b>15.00%</b> | <b>24.91%</b> | <b>25.10%</b> | <b>25.29%</b> |
| DISTANCE TO NEXT TAX BRACKET             | \$ 50,850     | \$ 47,050     | \$ 47,402     | \$ 32,834     | \$ 17,959     |
| DISTANCE TO FOLLOWING BRACKET            | 226,150       | 222,350       | Max           | Max           | Max           |
| AMOUNT ABOVE 39.6% BRACKET               | -             | -             | -             | -             | -             |

|   | 2013       | 2014      | 2015            | 2016            | 2017            |
|---|------------|-----------|-----------------|-----------------|-----------------|
| DISTANCE TO PEP/PEASE                   | \$ 100,000 | \$ 96,000 | \$ 119,345 Over | \$ 133,171 Over | \$ 147,613 Over |
| TAX COST OF PEP/PEASE                   | \$ -       | \$ -      | \$ 3,779        | \$ 4,090        | \$ 4,299        |
| RATE IMPACT OF PEP/PEASE                | 0.00%      | 0.00%     | 0.94%           | 0.98%           | 1.00%           |
| % OF ITEMIZED DEDUCTIONS LOST (MAX 80%) | 0.00%      | 0.00%     | 17.90%          | 19.98%          | 22.14%          |

# #1 Bracket Management

## *Bracket Management Example*

|  | 2013          | 2014          | 2015            | 2016            | 2017            |
|--|---------------|---------------|-----------------|-----------------|-----------------|
| MAGI LESS THRESHOLD (A)                        | \$ -          | \$ -          | \$ 169,345      | \$ 183,171      | \$ 197,613      |
| NET INVESTMENT INCOME (B)                      | 50,000        | 51,000        | 52,000          | 53,000          | 54,100          |
| LESSOR OF A OR B                               | \$ -          | \$ -          | \$ 52,000       | \$ 53,000       | \$ 54,100       |
| NIIT @ 3.8%                                    | \$ -          | \$ -          | \$ 1,976        | \$ 2,014        | \$ 2,056        |
| DISTANCE TO 3.8% NIIT<br>AMOUNT OVER THRESHOLD | 50,000<br>N/A | 46,000<br>N/A | Over<br>169,345 | Over<br>183,171 | Over<br>197,613 |

|  | 2013       | 2014       | 2015      | 2016      | 2017      |
|--|------------|------------|-----------|-----------|-----------|
| CAPITAL GAINS TAXED AT 0% PERCENT      | \$ -       | \$ -       | \$ -      | \$ -      | \$ -      |
| CAPITAL GAINS TAXED AT 15% PERCENT     | \$ 50,000  | \$ 51,000  | \$ 52,000 | \$ 53,000 | \$ 54,100 |
| CAPITAL GAINS TAXED AT 20% PERCENT     | \$ -       | \$ -       | \$ -      | \$ -      | \$ -      |
| DISTANCE TO NEXT CAPITAL GAINS BRACKET | \$ 277,800 | \$ 274,000 | \$ 47,402 | \$ 32,834 | \$ 17,959 |
| MARGINAL CAPITAL GAINS RATE            | 15.00%     | 15.00%     | 15.00%    | 15.00%    | 15.00%    |

|   | 2013      | 2014      | 2015      | 2016       | 2017       |
|---|-----------|-----------|-----------|------------|------------|
| REGULAR INCOME TAX  | \$ 29,908 | \$ 30,590 | \$ 98,843 | \$ 102,981 | \$ 107,194 |
| TENTATIVE MINIMUM TAX                                       | 28,742    | 29,516    | 102,491   | 106,724    | 111,160    |
| ALTERNATIVE TAX DUE   | \$ -      | \$ -      | \$ 3,648  | \$ 3,743   | \$ 3,966   |
| AMT EXEMPTION REMAINING<br>Appx. DISTANCE UNTIL AMT APPLIES | \$ 4,163  | \$ 3,836  | Applies   | Applies    | Applies    |

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# #1 Bracket Management *Strategies*

- Strategies:
  - Income smoothing strategies
  - Tax deferral strategies
- Maximize the benefit of tax rate arbitrage
- Remember: “Fly below the radar”





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## #2 Harvesting Capital Gain(s)

- Shifts recognition of part of the capital gain from the higher bracket future tax year to the lower bracket current tax year
  - Could save the taxpayer substantial amounts of capital gains tax
- How it works:
  - Taxpayer expects to be in a higher tax bracket in the future
  - Sell assets this year, pays tax on the gains at the lower current tax rate and steps-up the basis on the assets to the sale price
  - Immediately repurchases the assets and sells them whenever they would have been sold had the taxpayer not harvested gains
- Key variables to consider:
  - Time period between sales, difference in tax rates, growth rate of the asset, and taxpayer's opportunity cost of capital

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## #3 Harvesting Capital Loss(es)

- Selling assets at a loss and using those losses to offset capital gains realized on other assets
- How it works:
  - It reduces or eliminates current capital gain
  - Once the asset is repurchased, it gives the taxpayer a lower basis in the repurchased asset
  - Thus, it increases the amount of gain that is recognized when the asset is later sold
  - Therefore, total gain recognized is the same, but loss harvesting creates tax deferral
    - Provides only a timing benefit
- Long-term losses used to offset short-term gains are most tax-efficient

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## #4 Trusts as S Corporation Shareholders

- An ESBT provides greater flexibility while a QSST generally has more favorable tax treatment
- How it Works:
  - Qualified Subchapter S Trusts (QSST)
    - All trust income must be distributed
    - Only one current income beneficiary allowed
    - Trust income passes through to the income beneficiary and is taxed at the beneficiary's tax rate
  - Electing Small Business Trusts (ESBT)
    - Trust income distributions are discretionary
    - Unlimited number of current income beneficiaries allowed
    - Trust income is recognized at the trust level and is taxed at a flat rate equal to the highest marginal rate for corporations

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## **Section 2:**

# Income Smoothing Strategies

5. Substantial Sale CRT
6. Retirement CRT
7. Roth IRA Conversions and IRA Relocation
8. Oil & Gas Investments
9. Two-Year Installment Sales
10. Nonqualified Tax Deferred Annuities and the IRA-  
Annuity Strategy
11. Borrowing from Life Insurance

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## #5 Substantial Sale CRT

### *Definition of a Charitable Remainder Trust*

- A Charitable Remainder Trust (CRT) is a split interest trust consisting of an income interest and a remainder interest. During the term of the trust, the income interest is usually paid out to the donor (or some other named beneficiary). At the end of the trust term, the remainder (whatever is left in the trust) is paid to the charity or charities that have been designated in the trust document.

**PURPOSE OF STRATEGY (as it relates to the 3.8% NIIT):** To harbor “net investment income” in a tax-exempt environment while at the same time leveling income over a longer period of time to keep MAGI below the “threshold amount”.

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# #5 Substantial Sale CRT

## *Two Main Types of CRTs*

- Charitable Remainder Annuity Trust (CRAT)
  - The beneficiaries receive a stated amount of the initial trust assets each year
    - The amount received is established at the beginning of the trust and will not change during the term of the trust regardless of investment performance (unless inadequate investment performance causes the trust to run out of assets)
- Charitable Remainder Unitrust (CRUT)
  - Income beneficiaries receive a stated percentage of the trust's assets each year.
    - The distribution will vary from year to year depending on the investment performance of the trust assets and the amount withdrawn

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# #5 Substantial Sale CRT

## *Purposes*

- Charitable remainder trusts can be used to reduce or avoid surtax and incremental capital gains tax by smoothing out income
- CRTs are particularly useful when a taxpayer has a large capital gain that pushes income above the applicable threshold amount (ATA)
- Before explaining how the planning works, it will be helpful to look at some background information

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# #5 Substantial Sale CRT

## *Taxation*

- The donor will NOT realize gain or loss when property is transferred to the trust
- However, the grantor may be required to recognize gain if:
  - Property transferred is subject to indebtedness that exceeds grantor basis
  - Grantor receives property from the trust in exchange for the transfer to the trust.
- The donor will NOT realize gain or loss if and when the transferred assets are subsequently sold by the trustee of the CRT



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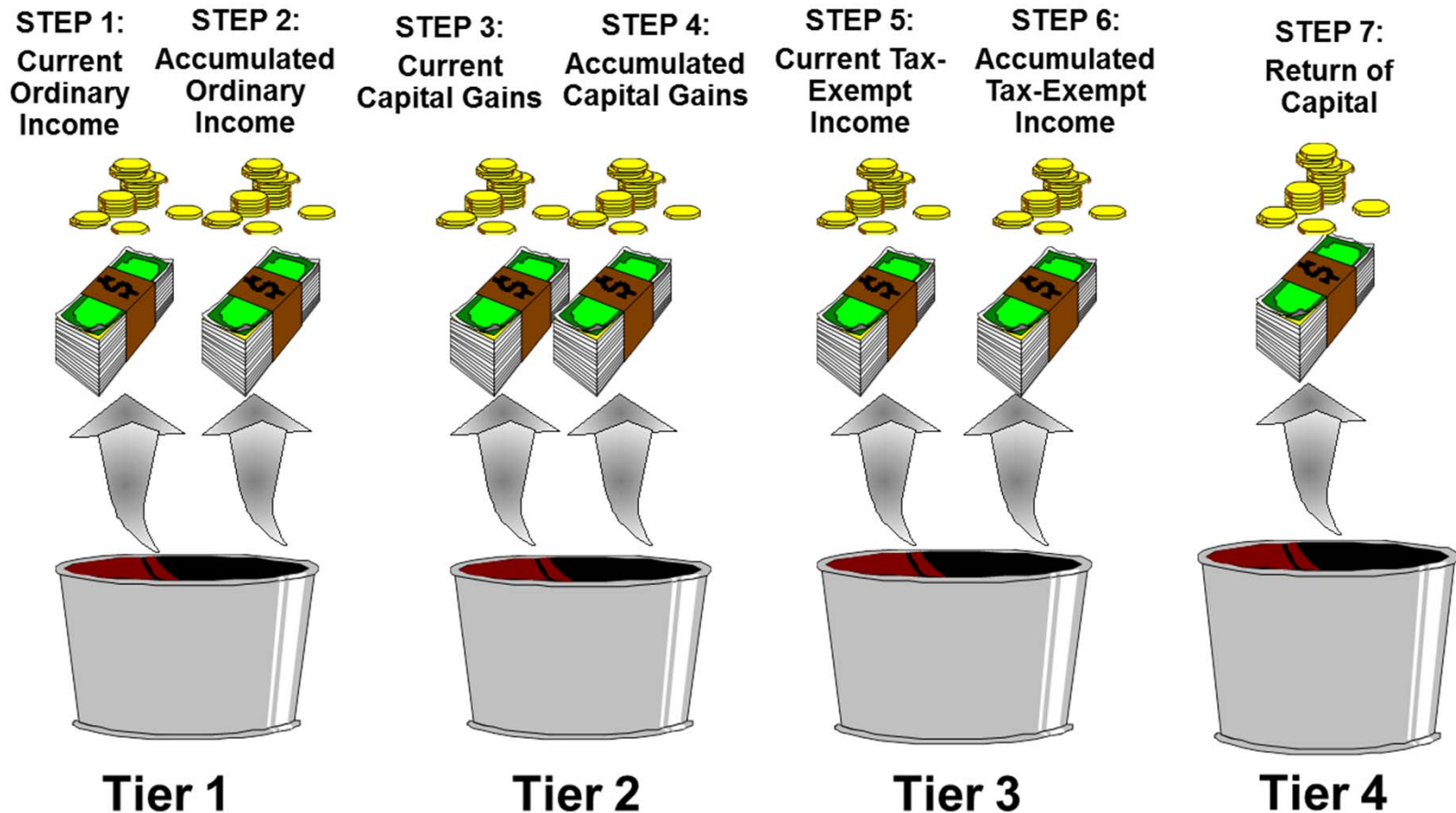
# #5 Substantial Sale CRT

## *Taxation (continued)*

- The character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b)
  - First, distributions are taxed as ordinary income
  - Second, distributions are taxed as capital gains
  - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
  - Finally, distributions are assumed to be the non-taxable return of principal
- CRTs are not subject to the 3.8% surtax
  - However, see Reg. Section 1.1411-3(d) for special rules on how the distributions of NII are taxed to beneficiaries

# #5 Substantial Sale CRT

## *Taxation (continued)*



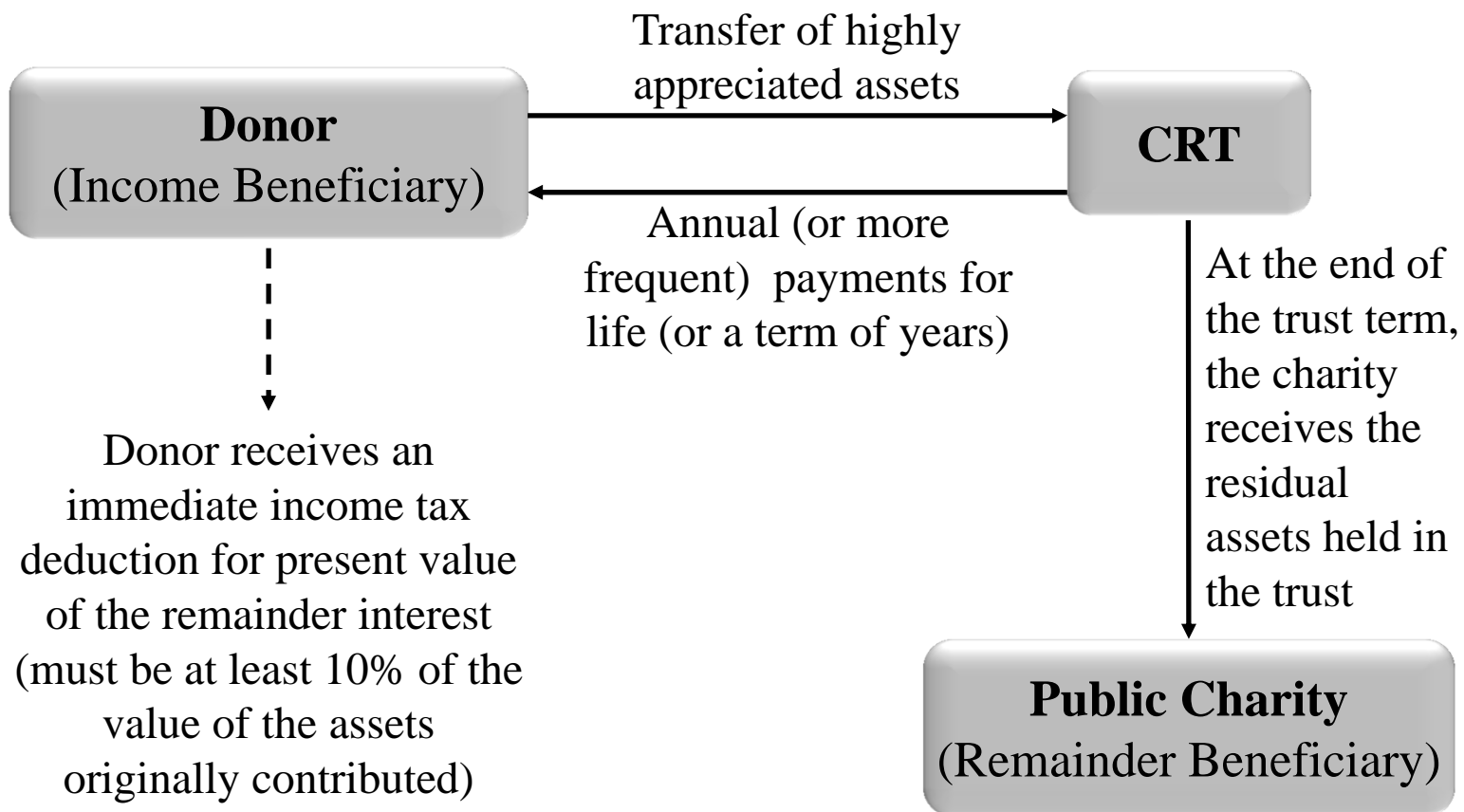
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# #5 Substantial Sale CRT

## *Strategy*

- Substantial Sale CRT (Standard CRT)
  - CRT to eliminate or reduce/defer the 3.8% Surtax and 5% incremental capital gains tax
  - Strategy:
    - Taxpayer has a large capital gain that will push them into the higher tax brackets and/or subject them to the NIIT
    - Instead, Taxpayer contributes the appreciated asset to a CRT
    - CRT sells it without recognizing gain
    - Gain realized by the trust is taxed to the grantor, but only as the annuity or unitrust payments are received
    - Thus, allowing the gain to be spread out over many years and potentially avoiding the higher tax brackets and NIIT
  - The worst case scenario is tax deferral, while the best case scenario is tax rate arbitrage

# #5 Substantial Sale CRT *Strategy*



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# #5 Substantial Sale CRT

## *Example*

T has a \$1 million stock position with \$0 basis.

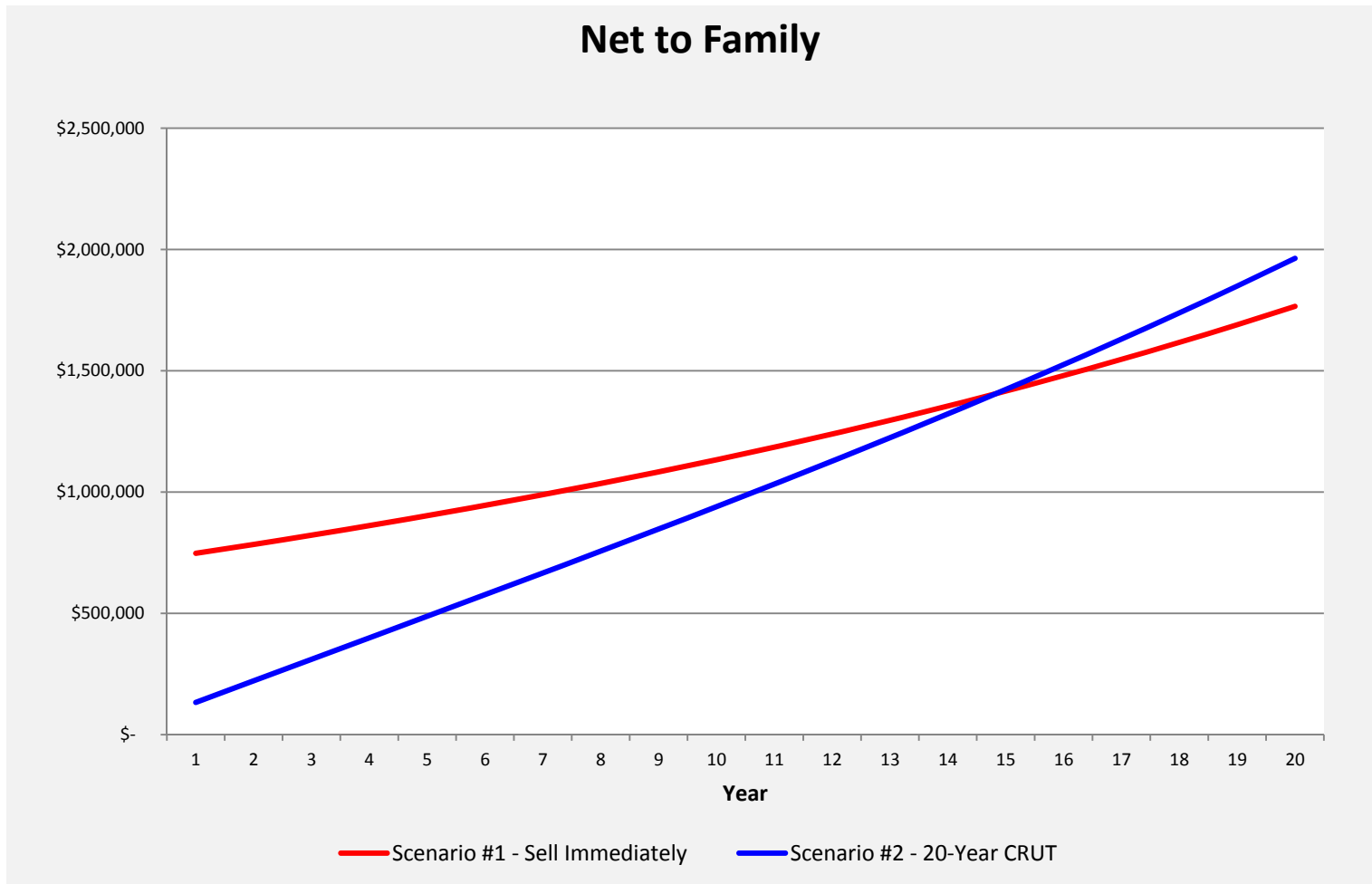
- Scenario 1 – T sells the entire position, incurring 20% capital gains tax, 3.8% net investment income tax, and 5% state tax.
- Scenario 2 – T moves the entire position to a 20-year CRUT.
  - The CRUT is assumed to distribute at 11.093%\* rate per year after 1 year.
  - Tax savings from charitable donation is reinvested

In both scenarios, a 4% growth rate and 1.5% yield is assumed for assets

\*Rate as of 8/13

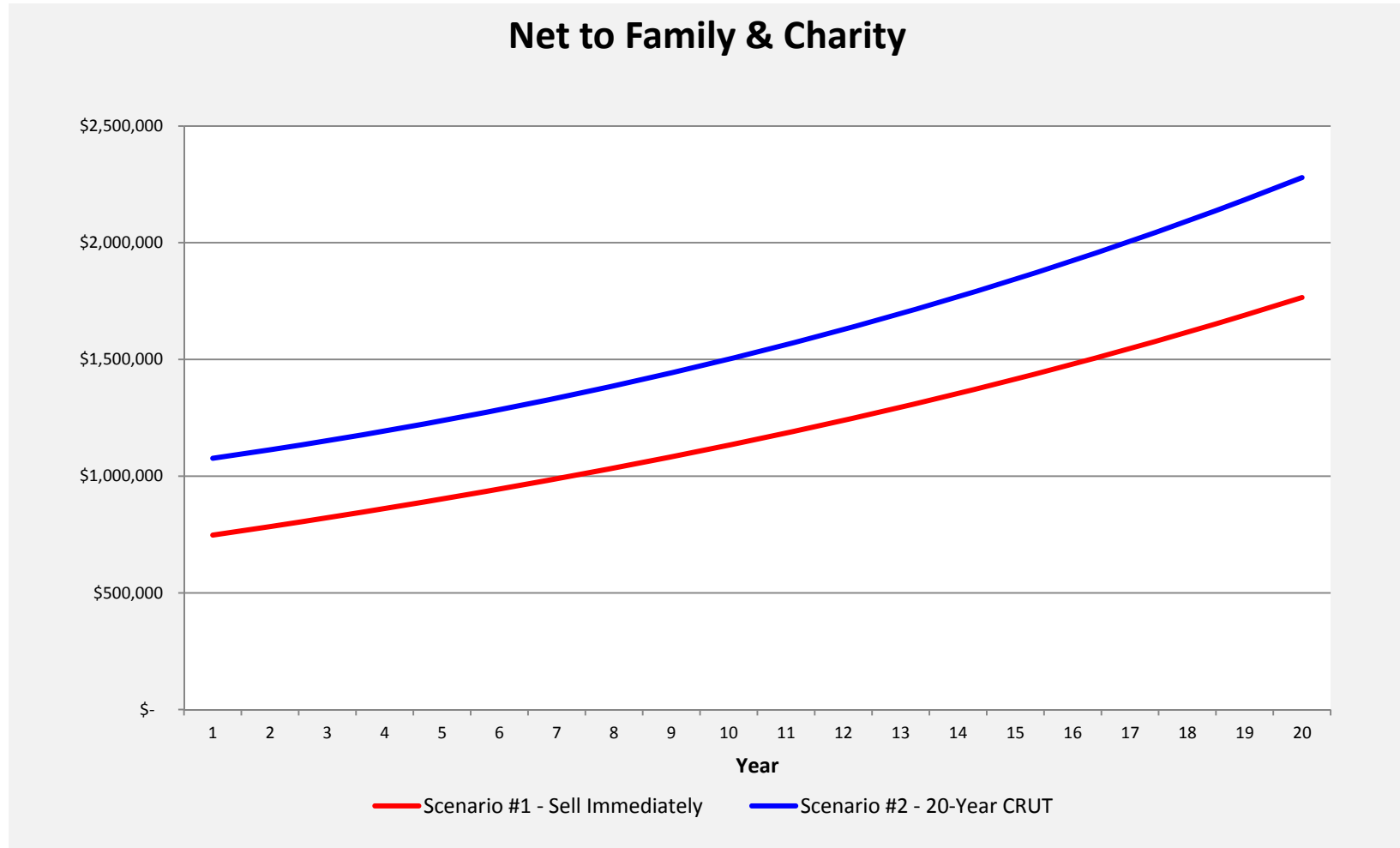
# #5 Substantial Sale CRT

*Example (continued)*



# #5 Substantial Sale CRT

## *Example (continued)*



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# #6 Retirement CRT

## *Overview*

- Basic CRT overview is the same as in previous slides #29 - #34
- Retirement CRT
  - CRT to eliminate or reduce the 3.8% surtax and 5% incremental capital gains tax while deferring income until after retirement
  - NIMCRUT: Pays the settlor the lesser of a fixed percentage of the trust assets or the net trust income



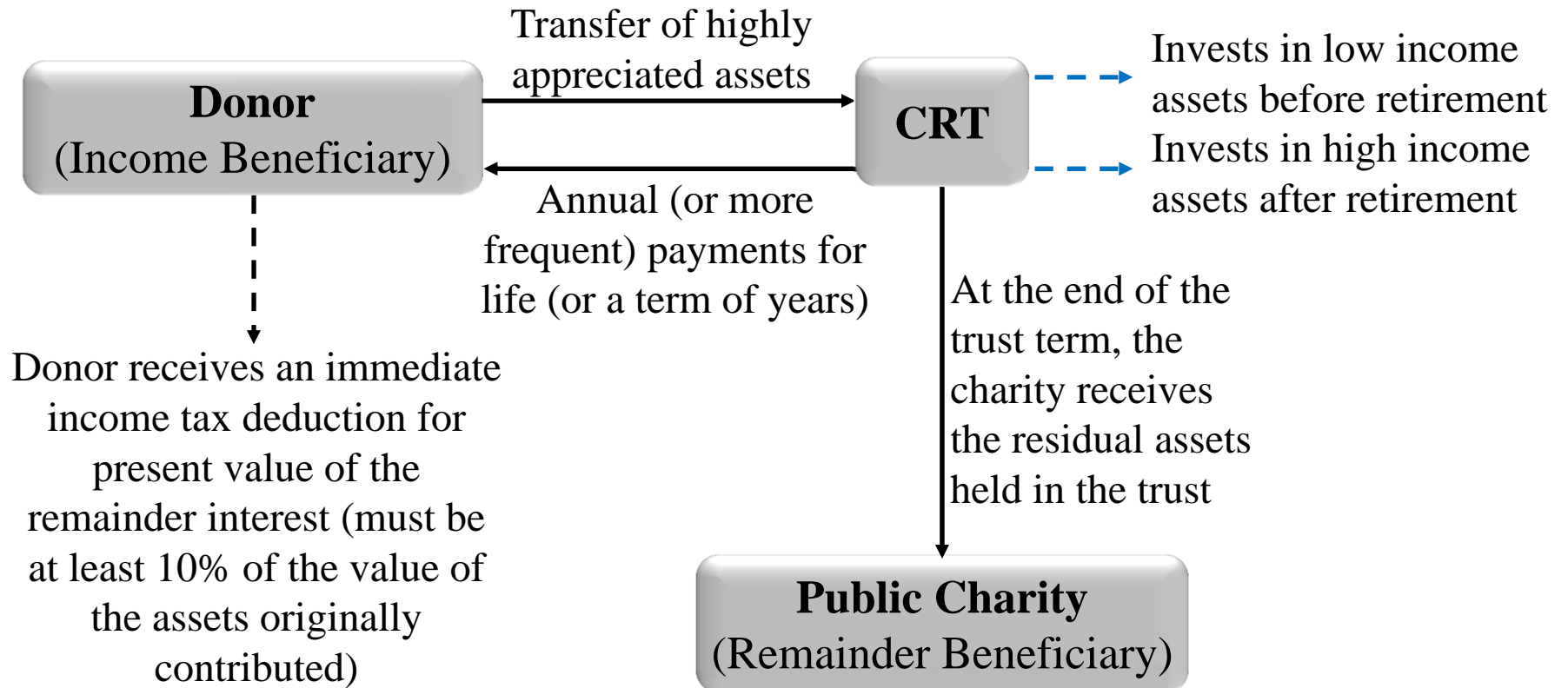
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# #6 Retirement CRT

## *Strategy*

- Strategy:
  - Minimize trust distributions before retirement
    - NIMCRUT invests in assets that produce very low income
    - It makes small distributions and accumulates gain tax-free
  - Maximize trust distributions after retirement
    - NIMCRUT invests in assets that maximize trust income
    - Creates trust income that exceeds the fixed percentage and allows for amounts to be paid out of the make-up account
- Income smoothing to avoid high tax brackets and NIIT

# #6 Retirement CRT *Strategy*



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# #6 Retirement CRT

## *Example*

T has a \$1 million stock position with \$0 basis.

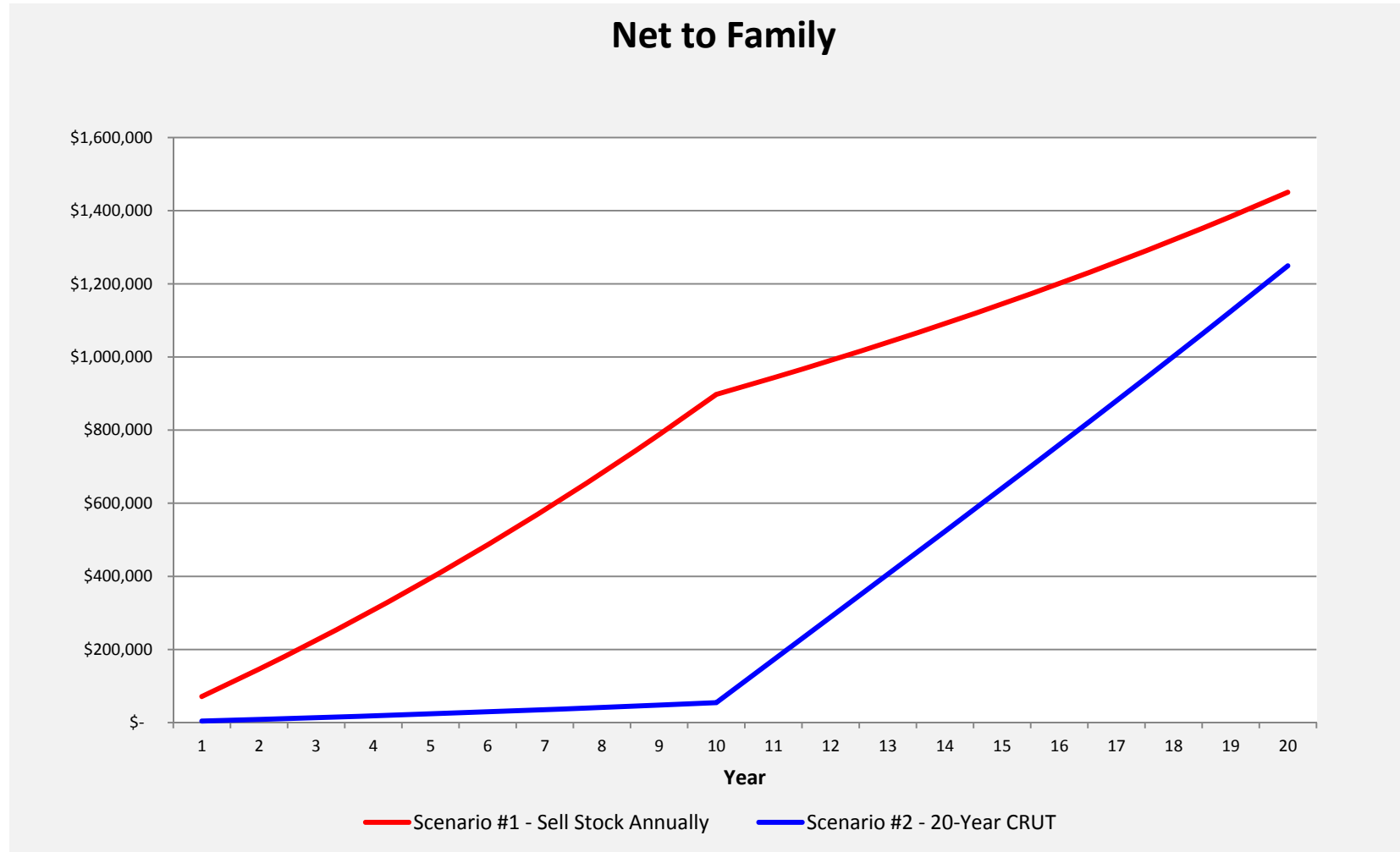
- Scenario 1 – T sells the position in increments over 10 years, incurring 20% capital gains tax, 3.8% net investment income tax, and 5% state tax each year.
- Scenario 2 – T moves the stock to a 20-year CRUT in the same increments over 10 years.
  - The CRUT is assumed to distribute at 11.093%\* rate per year after 10 years.
  - Tax savings from charitable donation is reinvested

In both scenarios, a 4% growth rate and 1.5% yield is assumed for assets

\*Rate as of 8/13

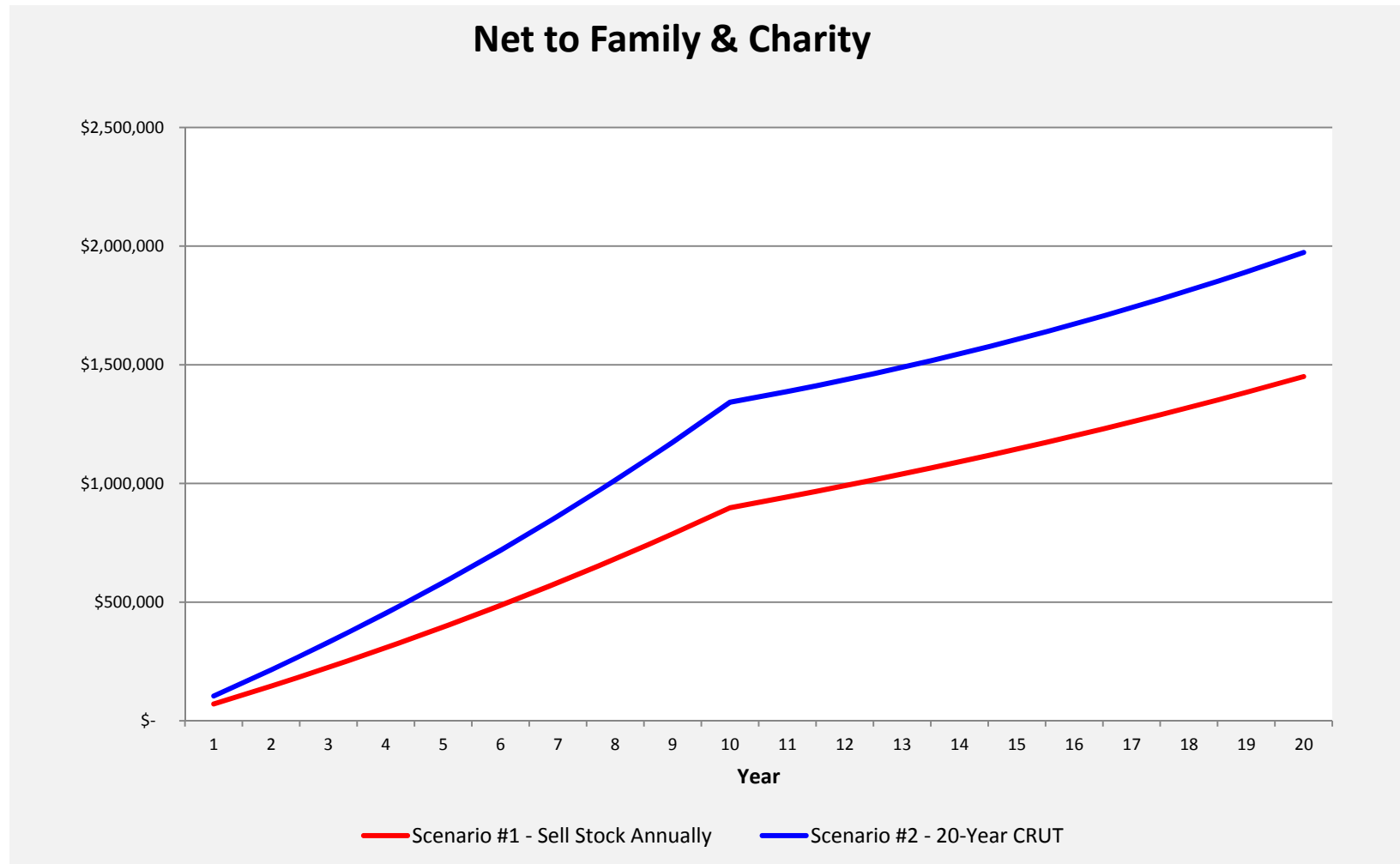
# #6 Retirement CRT

## *Example (continued)*



# #6 Retirement CRT

## *Example (continued)*



# #7 Roth IRA Conversions

## *Roth IRA Benefits*

- Lowers overall taxable income long-term
- Tax-free compounding
- No RMDs at age 70½
- 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 (as it relates to the 3.8% NIIT):** To lower MAGI below the “threshold amount” over the long-term.

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# #7 Roth IRA Conversions

## *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 70½ provides a considerable advantage to the Roth IRA holder.

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# #7 Roth IRA Conversions

## *Reasons to Convert (continued)*

- 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.



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# #7 Roth IRA Conversions

## *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

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# #7 Roth IRA Conversions

## *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
    - $A \times B \times C = D$
    - $A \times C \times B = D$

# #7 Roth IRA Conversions

## *Mathematics of Conversion (continued)*

|                                      | <u>Traditional IRA</u> | <u>Roth IRA</u>     | <u>Life Insurance</u> |
|--------------------------------------|------------------------|---------------------|-----------------------|
| Current Account Balance              | \$ 1,000,000           | \$ 1,000,000        | \$ 1,000,000          |
| Less: Income Taxes @ 40%             | -                      | (400,000)           | (400,000)             |
| <b>Net Balance</b>                   | <b>\$ 1,000,000</b>    | <b>\$ 600,000</b>   | <b>\$ 600,000</b>     |
| <br>                                 |                        |                     |                       |
| Growth Until Death                   | 200.00%                | 200.00%             | 200.00%               |
| <br>                                 |                        |                     |                       |
| Account Balance @ Death              | \$ 3,000,000           | \$ 1,800,000        | \$ 1,800,000          |
| Less: Income Taxes @ 40%             | (1,200,000)            | -                   | -                     |
| <b>Net Account Balance to Family</b> | <b>\$ 1,800,000</b>    | <b>\$ 1,800,000</b> | <b>\$ 1,800,000</b>   |

(Note: Life Insurance should be held in an ILIT)

---

# #7 Roth IRA Conversions

## *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

---

# #7 Roth IRA Conversions

## *Mathematics of Conversion*

- The key to successful Roth IRA conversions is to keep as much of the conversion income as possible in the current marginal tax bracket
  - However, there are times when it may make sense to convert more and go into higher tax brackets
  - Need to take into consideration the following:
    - The new 3.8% NIIT
    - The impact of AMT
    - New higher tax brackets (39.6% OI rate and 20% CG rate)
    - PEP and PEASE adjustments

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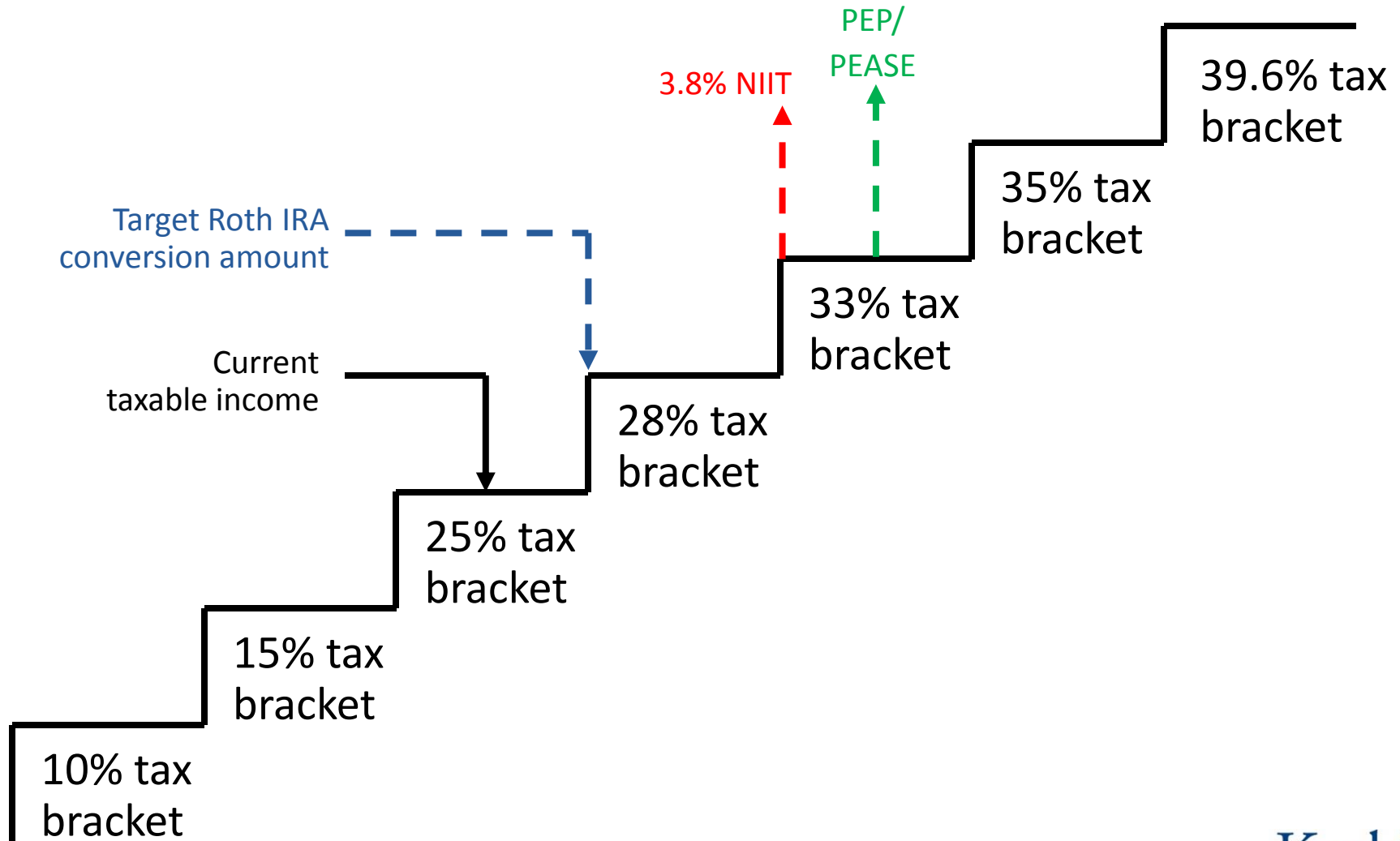
# #7 Roth IRA Conversions

## *Tactical Considerations*

- Unused charitable contribution carryovers
- Current year ordinary losses
- Net Operating Loss (NOL) carryovers from prior years
- Alternative Minimum Tax (AMT)
- Credit carryovers

# #7 Roth IRA Conversions

## Target Roth IRA Conversion Amount



---

# #7 Roth IRA Conversions

## *Recharacterization*

- Taxpayers may “recharacterize” (i.e. undo) the Roth IRA conversion in current year or by the filing date of the current year’s tax return
  - Recharacterization can take place as late as 10/15 in the year following the year of conversion
- Taxpayers may choose to “reconvert” their recharacterization
  - Reconversion may only take place at the later of the following two dates:
    - The tax year following the original conversion OR
    - 30 days after the recharacterization



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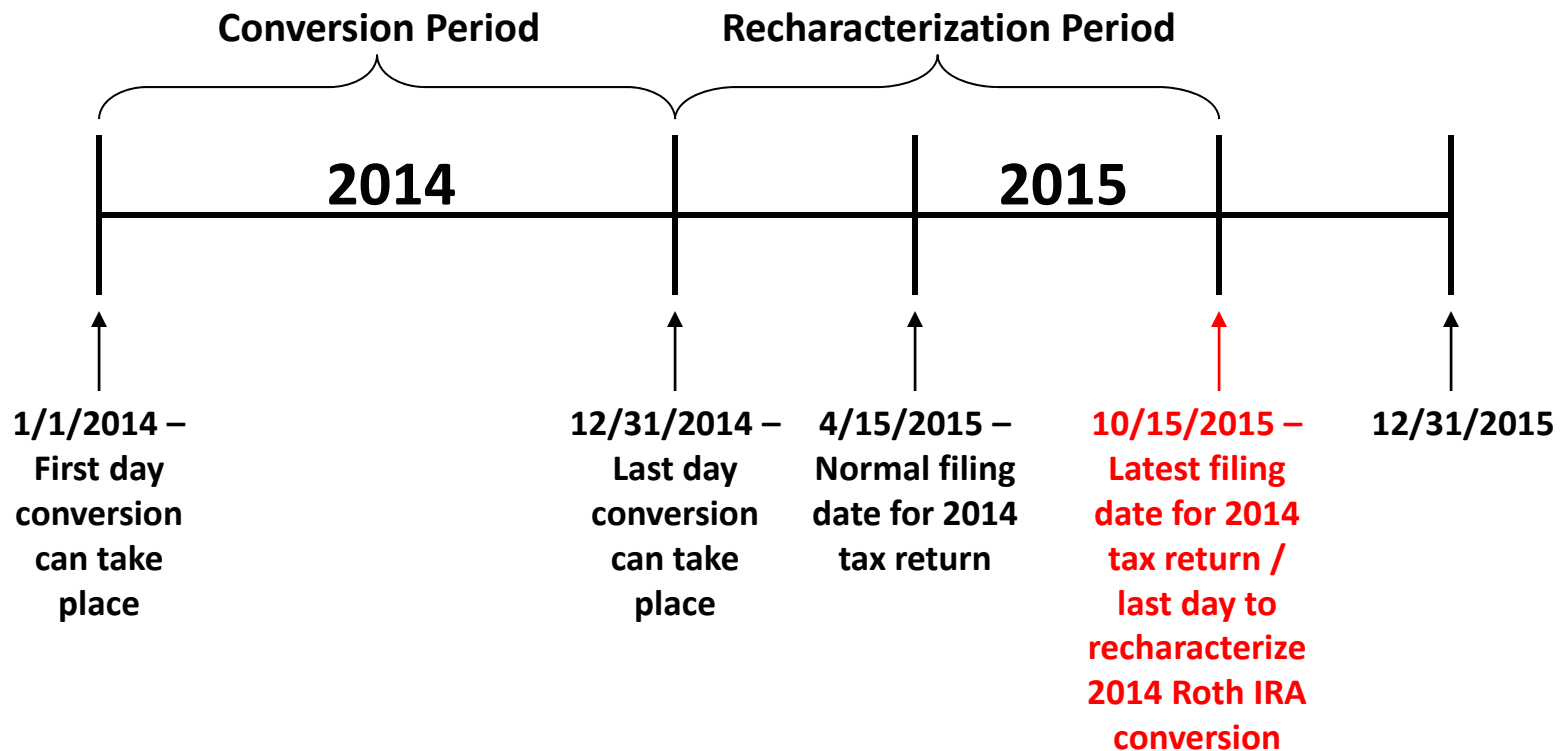
# #7 Roth IRA Conversions

## *Recharacterization (continued)*

- Cannot recharacterize a portion of a Roth conversion by “cherry picking” only those stocks that decline in value
- All gains and losses to the entire Roth IRA must be pro-rated
- Therefore, set up a separate Roth IRA for each asset class
  - Allowing you to recharacterize only those Roth IRAs that asset class declined

# #7 Roth IRA Conversions

## *Recharacterization Timeline*



---

# #7 Roth IRA Conversions

## *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, impact of PEP/Pease, or the 39.6% tax rate

---

# #7 Roth IRA Conversions

## *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 various taxes.
- Step 4: Repeat the above taking into account changes in value and the opportunity to recharacterize

---

# #7 IRA Relocation

## *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

# #7 IRA Relocation

## *Comparison*

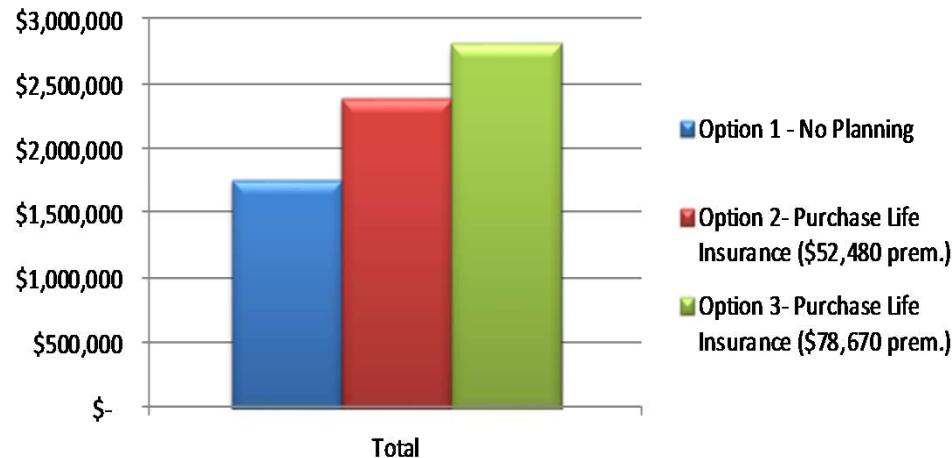
|                                      | <u>Traditional IRA</u> | <u>Roth IRA</u>     | <u>Life Insurance</u> |
|--------------------------------------|------------------------|---------------------|-----------------------|
| Current Account Balance              | \$ 1,000,000           | \$ 1,000,000        | \$ 1,000,000          |
| Less: Income Taxes @ 40%             | -                      | (400,000)           | (400,000)             |
| <b>Net Balance</b>                   | <b>\$ 1,000,000</b>    | <b>\$ 600,000</b>   | <b>\$ 600,000</b>     |
| <br>                                 |                        |                     |                       |
| Growth Until Death                   | 200.00%                | 200.00%             | 200.00%               |
| <br>                                 |                        |                     |                       |
| Account Balance @ Death              | \$ 3,000,000           | \$ 1,800,000        | \$ 1,800,000          |
| Less: Income Taxes @ 40%             | (1,200,000)            | -                   | -                     |
| <b>Net Account Balance to Family</b> | <b>\$ 1,800,000</b>    | <b>\$ 1,800,000</b> | <b>\$ 1,800,000</b>   |

# #7 IRA Relocation

## Comparison (continued)

### 28% Tax Rate

| Option 1 - No Planning          |                     | Option 2- Purchase Life Insurance (\$52,480 prem.) |                     | Option 3- Purchase Life Insurance (\$78,670 prem.) |                     |
|---------------------------------|---------------------|--|---------------------|--|---------------------|
| IRA value @ death               | \$ 1,566,584        | IRA value @ death                                  | \$ 663,058          | IRA value @ death                                  | \$ 212,156          |
| Less: Built-in tax liability(2) | (438,643)           | Less: Built-in tax liability(2)                    | (185,656)           | Less: Built-in tax liability(2)                    | (59,404)            |
| Net                             | \$ 1,127,940        | Net  | \$ 477,402          | Net  | \$ 152,752          |
| Reinvestment account @ death(3) | 646,400             | Reinvestment account @ death(3)                    | 273,589             | Reinvestment account @ death(3)                    | 87,539              |
| Total                           | <u>\$ 1,774,340</u> | Insurance proceeds                                 | 1,653,389           | Insurance proceeds                                 | 2,576,700           |
|                                 |                     | Total  | <u>\$ 2,404,380</u> | Total  | <u>\$ 2,816,991</u> |



---

# #8 Oil and Gas Investments

- How it works:
  - Investors can deduct 100% of their share of intangible drilling costs (IDCs) in the year they are incurred
    - Typically produce deductions equal to 65%-85% of the total investment
  - Used to create a large deduction in a high income year, thereby avoiding the higher tax brackets and NIIT
    - Used to offset active income from wages, interest, business profits, or capital gains
- Additional Tax Benefits
  - Tangible drilling costs: 100% written off over a 7-year period
  - IDCs are excluded as a tax preference item for the AMT purposes
  - Depletion deductions



---

# #9 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 (as it relates to the 3.8% NIIT):** To level “net investment income” over a longer period of time so as to keep MAGI below the “threshold amount”.

Note: the sale of a non-passive interest in a trade or business is not subject to the NIIT. (See Section 1411(c)(4) and Reg. Section 1.1411-7)

---

# #9 Two-Year Installment Sale

## *Overview (continued)*

- 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)

---

# #9 Two-Year Installment Sale

## *Increase in Basis*

- Sale from taxpayer to a non-grantor trust or a child receives a basis increase
  
- Basis will equal the purchase price

---

# #9 Two-Year Installment Sale

## *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

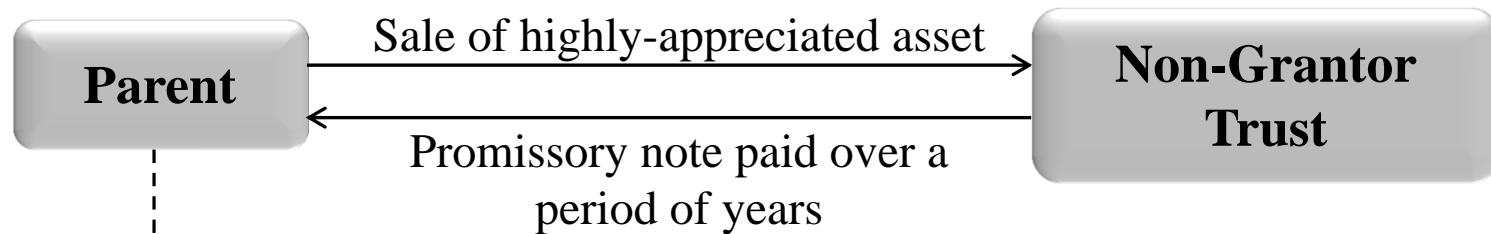
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# #9 Two-Year Installment Sale

## *Strategy*

- 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

# #9 Two-Year Installment Sale *Strategy*



↓

Taxable gain is deferred  
until payments on  
principal are made

---

# #9 Two-Year Installment Sale

## *Benefits*

- Benefits
  - Income smoothing: Avoids the higher tax brackets & NIIT
  - Timing benefit: Children cash in the full appreciated value of the asset before most the gain is recognized by the parents.

---

# #10 Deferred Annuities

- How it works:
  - A taxpayer, during higher tax bracket years, invests in deferred annuities
    - Thereby reducing taxable income, and thus, income taxes and NIIT
  - Later, when the taxpayer is in lower tax bracket years, the payments from the deferred annuities begin
    - Thus, smoothing out income and subjecting the taxpayer to lower taxes
- Benefits
  - Earnings accumulate tax-free and are not taxed until withdrawn
  - Flying below the radar



---

# #11 Borrowing from Life Insurance Policies

- Loans from permanent life insurance policies can be used to shift income from years when a taxpayer is in a higher tax bracket to years when the taxpayer is in a lower tax bracket
- How it works:
  - Taxpayer pays into a policy in high income years
    - Use the funds that would otherwise produce income in the higher tax brackets and subject to the NIIT
  - Later, if taxpayer needs additional income, they can increase their available funds, without selling assets and pushing themselves into a higher tax bracket, by borrowing funds from the policy
  - Funds borrowed against the policy are generally not taxable
    - Unless the policy lapses, is surrendered, or is a MEC

---

# Section 3: Income Shifting Strategies

12. Income Shifting CRT

13. Family Limited Partnership

---

# #12 Income Shifting CRT

## *Overview*

- Basic CRT overview is the same as in previous slides #29 – #34
- Income Shifting CRT
  - A CRT for the donor's children; i.e., the donor's children are the beneficiaries of the lead annuity or unitrust interest
  - CRT to eliminate or reduce/defer the 3.8% surtax and 5% incremental capital gains tax while shifting the incidence of taxation to children and grandchildren

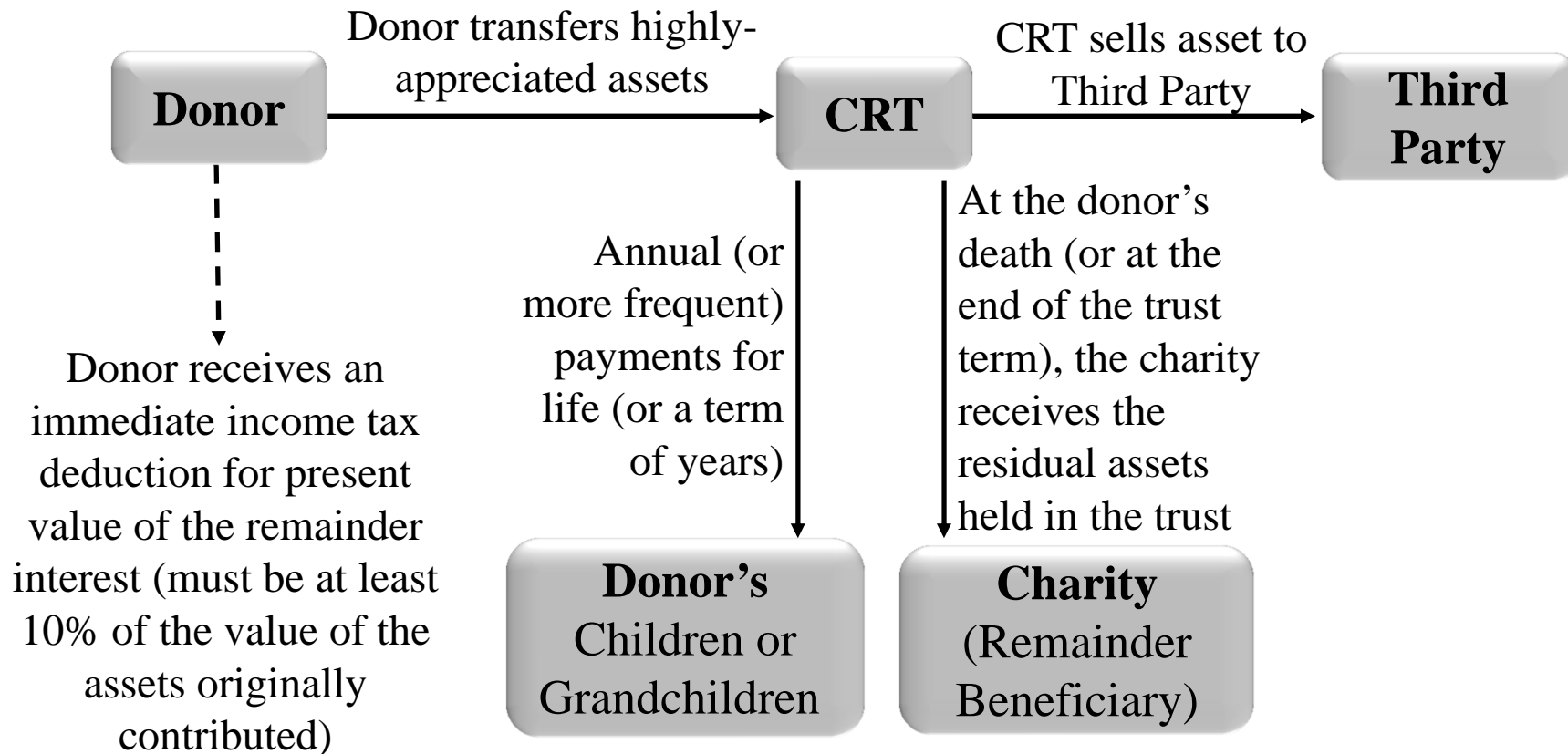
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# #12 Income Shifting CRT

## *Strategy*

- Strategy:
  - Parent contributes assets to a CRT with the Parent's children as the lead income beneficiaries
  - Therefore reducing or eliminating the Parent's NIIT and income in the higher tax brackets by shifting income to their children
- Effects
  - Shifts ordinary income to family
  - Shift capital gains to family members
  - Benefit charity

# #12 Income Shifting CRT *Strategy*



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# #12 Income Shifting CRT

## *Example*

T has a \$1 million stock position with \$0 basis.

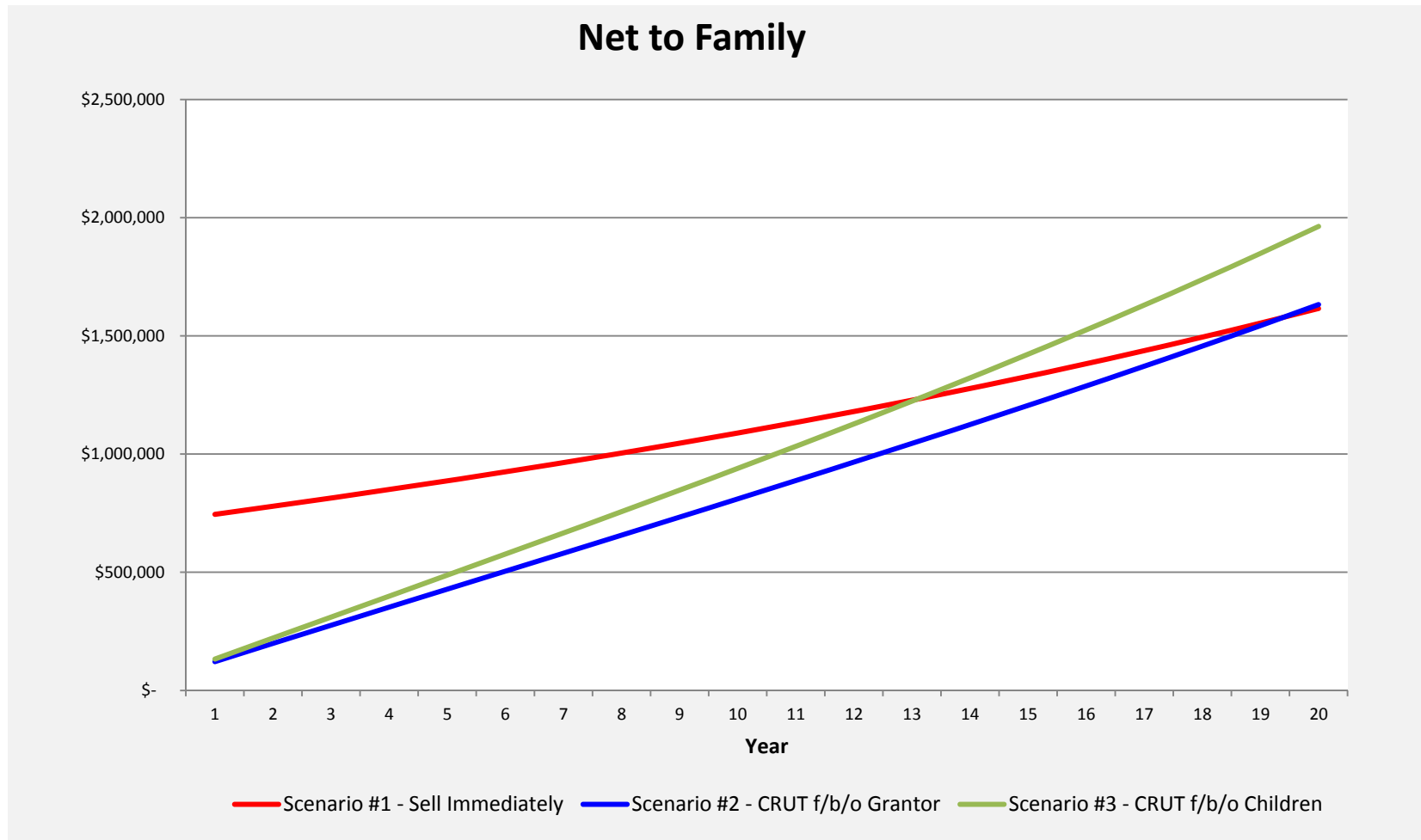
- Scenario 1 – T sells the entire position, incurring 20% capital gains tax, 3.8% net investment income tax, and 5% state tax.
- Scenario 2 – T moves the entire position to a 20-year CRUT, *for his own benefit*
  - The CRUT is assumed to distribute at 11.093%\* rate per year after 1 year.
  - Tax savings from charitable donation is reinvested
- Scenario 3 – T moves the entire position to a 20-year CRUT, *for the benefit of his children*
  - The CRUT is assumed to distribute at 11.093%\* rate per year after 1 year.
  - Tax savings from charitable donation is reinvested
  - The children will have a 15% rate on Federal Capital Gains.

In both scenarios, a 4% growth rate and 1.5% yield is assumed for assets

\*Rate as of 8/13

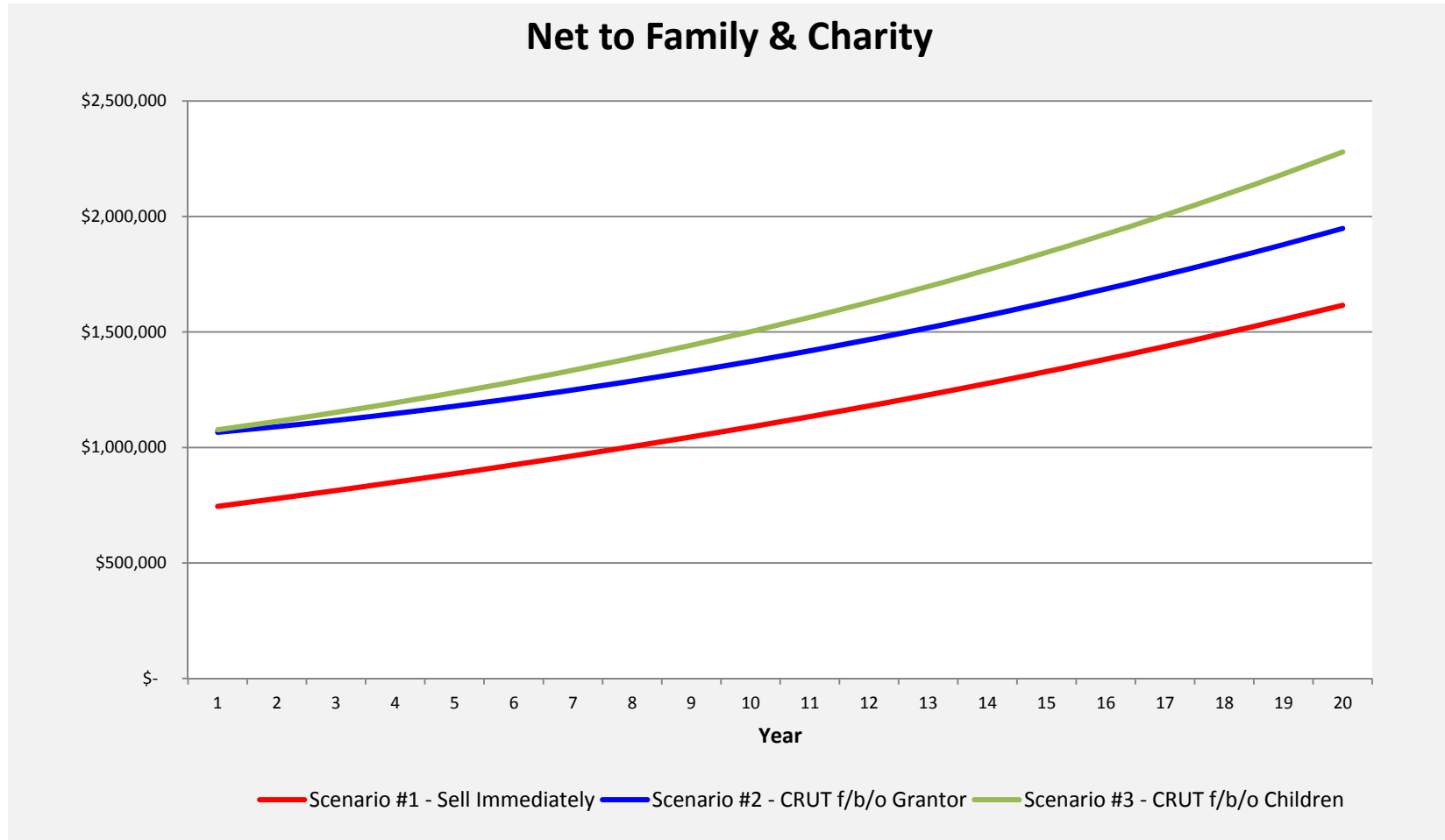
# #12 Income Shifting CRT

## *Example (continued)*



# #12 Income Shifting CRT

## *Example (continued)*





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# #13 Family Limited Partnership

## *Strategy*

- Strategy:
  - One or both parents create the FLP and serve as the general partner(s), while the children and/or grandchildren serve as the limited partners.
  - Initially, the parents hold both the general partner interests and the limited partner interests.
    - Typically, the general partner interest will be as little as 1% of the total equity in the FLP and the limited partner interest will be the remainder of the equity in the FLP so it can be divided up among the children and/or grandchildren by the parents.

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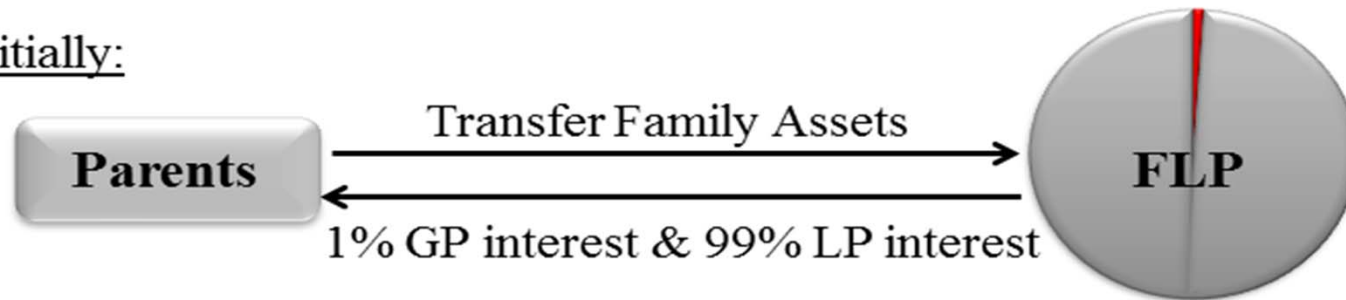
# #13 Family Limited Partnership

## *Strategy (continued)*

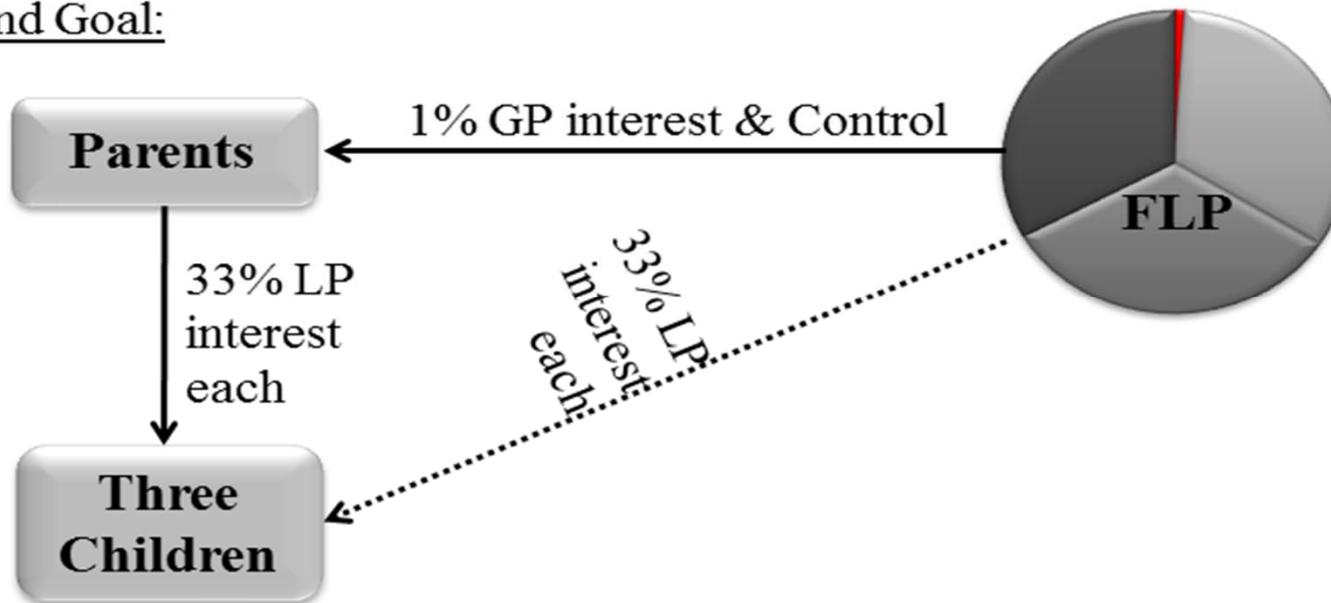
- Strategy:
  - The parents, as general partners, maintain full and complete control over the FLP while gifting as many of the limited partner units to their children as they desire; thus, reducing their taxable estates.
  - Furthermore, gift tax and use of the applicable exclusion amount can be avoided if the value of the units transferred to each child does not exceed the annual exclusion amount
    - \$14,000 per donee in 2014
  - If Parents wish to transfer assets faster, they can still avoid gift tax by using their AEA.
    - \$5.34 million per donor in 2014 (\$10.68 million combined)
  - Valuation discounts allow even more value to be transferred

# #13 Family Limited Partnership Strategy (continued)

Initially:



End Goal:



---

# #13 Family Limited Partnership

## *Benefits*

- Benefits
  - Parents able to share the value of the assets with children
  - Parents able to maintain control over the assets
  - Assets transferred to the FLP are taken out of the parent's estate, generally at a substantially reduced transfer tax value.
    - Use the annual exclusion amount to avoid gift tax
    - Use the applicable exclusion amount to avoid gift tax
  - Income shifting from parents to children
    - FLP income is distributed to children as limited partners
  - Provides asset protection

---

## **Section 4:**

# Strategies for Reducing Taxable Income

14. Tax-Aware Investing

15. Nevada Incomplete Gift, Non-Grantor (NING)  
Trusts

16. Captive Insurance Companies

---

# #14 Tax Aware Investing

## *Overview*

- Taxes are the biggest drag on investment performance
- It is not what you earn that counts, but what you keep after taxes

# #14 Tax Aware Investing

## *Example*

- *Example:* Depending on the tax rate, the accumulation of investing \$10,000/year for 40 years at a 8% pretax rate of return will differ dramatically:

| Tax Rate | After-Tax Growth Rate* | Final Value |
|----------|------------------------|-------------|
| 0%       | 8.0%                   | \$2,590,656 |
| 10%      | 7.2%                   | \$2,102,199 |
| 20%      | 6.4%                   | \$1,712,216 |
| 30%      | 5.6%                   | \$1,400,380 |
| 40%      | 4.8%                   | \$1,150,637 |
| 50%      | 4.0%                   | \$950,255   |

\*After-tax growth rate = 8% x (1-tax rate)

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# #14 Tax Aware Investing

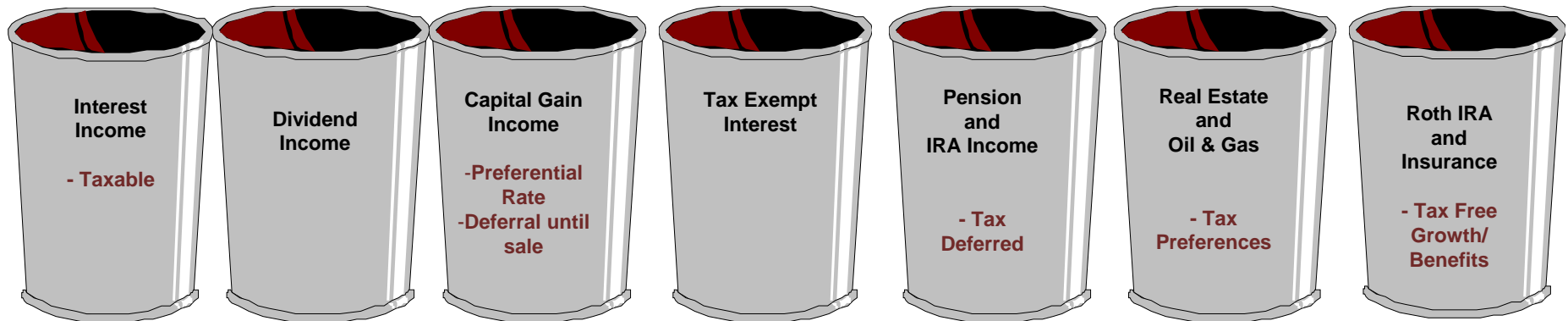
## *Strategy*

- Strategies for tax-aware investing:
  - Increasing investment in tax-favored assets
  - Deferring gain recognition
  - Changing portfolio construction
  - After-tax asset allocation
  - Tax-sensitive asset location
  - Managing income, gains, losses and tax brackets from year-to-year
  - Managing capital asset holding periods



# #14 Tax Aware Investing

## Tax Asset Classes



- ✓ Money market
- ✓ Corporate bonds
- ✓ US Treasury bonds

Attributes

- ✓ Annual income tax on interest
- ✓ Taxed at highest marginal rates

- ✓ Equity securities
- Attributes
- ✓ Qualified dividends at LTCG rate
  - ✓ Return of capital dividend
  - ✓ Capital gain dividends

- ✓ Equity Securities
- Attributes
- ✓ Deferral until sale
  - ✓ Reduced capital gains rate
  - ✓ Step-up basis at death

- ✓ Bonds issued by State and local Governmental entities
- Attributes
- ✓ Federal tax exempt
  - ✓ State tax exempt

- ✓ Pension plans
  - ✓ Profit sharing plans
  - ✓ Annuities
- Attributes
- ✓ Growth during lifetime
  - ✓ RMD for IRA and qualified plans
  - ✓ No step-up

- Real Estate
- ✓ Depreciation tax shield
  - ✓ 1031 exchanges
  - ✓ Deferral on growth until sale

- Oil & Gas
- ✓ Large up front IDC deductions
  - ✓ Depletion allowances

- Roth IRA
- ✓ Tax-free growth during lifetime
  - ✓ No 70½ RMD
  - ✓ Tax-free distributions out to beneficiaries life expectancy

- Life Insurance
- ✓ Tax-deferred growth
  - ✓ Tax-exempt payout at death

---

# #15 Nevada Incomplete Gift, Non-Grantor (NING) Trust(s)

- Taxpayers in high tax states should consider transferring assets to a trust in a state that does not tax trust income to avoid income tax in their home state
- How it works:
  - The trust must be created in a state that does not tax trust income
  - The income from the trust must not be taxable by the grantor's home state
  - The trust must allow discretionary distributions to the settlor without making the trust a grantor trust
  - Transfers to the trust must be incomplete gifts for federal gift tax purposes without making the trust a grantor trust
    - However, the permanent increase in the applicable exclusion amount and emergence of DAPTs may allow for completed gifts

---

# #16 Captive Life Insurance Company

- A captive is a privately held insurance company that is a subsidiary of a parent company that is formed to insure risks of the parent company's subsidiaries
- Formalizes a business' uninsured, self-insured and underinsured risk management programs
- How it works:
  - Parent company can deduct premiums paid up to \$1,200,000/year
  - The captive can exclude premium income up to \$1,200,000/year
  - Insured with pre-tax dollars
  - Premiums paid in excess of the captive's claims and expenses each year are put in an earned surplus account which can be used for multiple purposes
    - E.g., invested, distributed as dividends, loaned, etc.

---

# **Section 5:**

## **Specific Strategies for Reducing NIIT**

- 17. Inter Vivos CLAT
- 18. Grouping Business Activities to Create Material Participation
- 19. Choice of Filing Status

---

# #17 Inter Vivos CLAT

## *Overview*

A Charitable Lead Trust (CLT) is a split interest trust consisting of an income interest and a remainder interest. During the term of the trust, the income interest is paid out to a named charity. At the end of the trust term, the remainder (whatever is left in the trust) is paid to non-charitable beneficiaries (e.g. children of the donor) that have been designated in the trust document.

**PURPOSE OF STRATEGY (as it relates to the 3.8% NIIT):** To offset “net investment income” against charitable deductions dollar-for-dollar in a tax-efficient manner.

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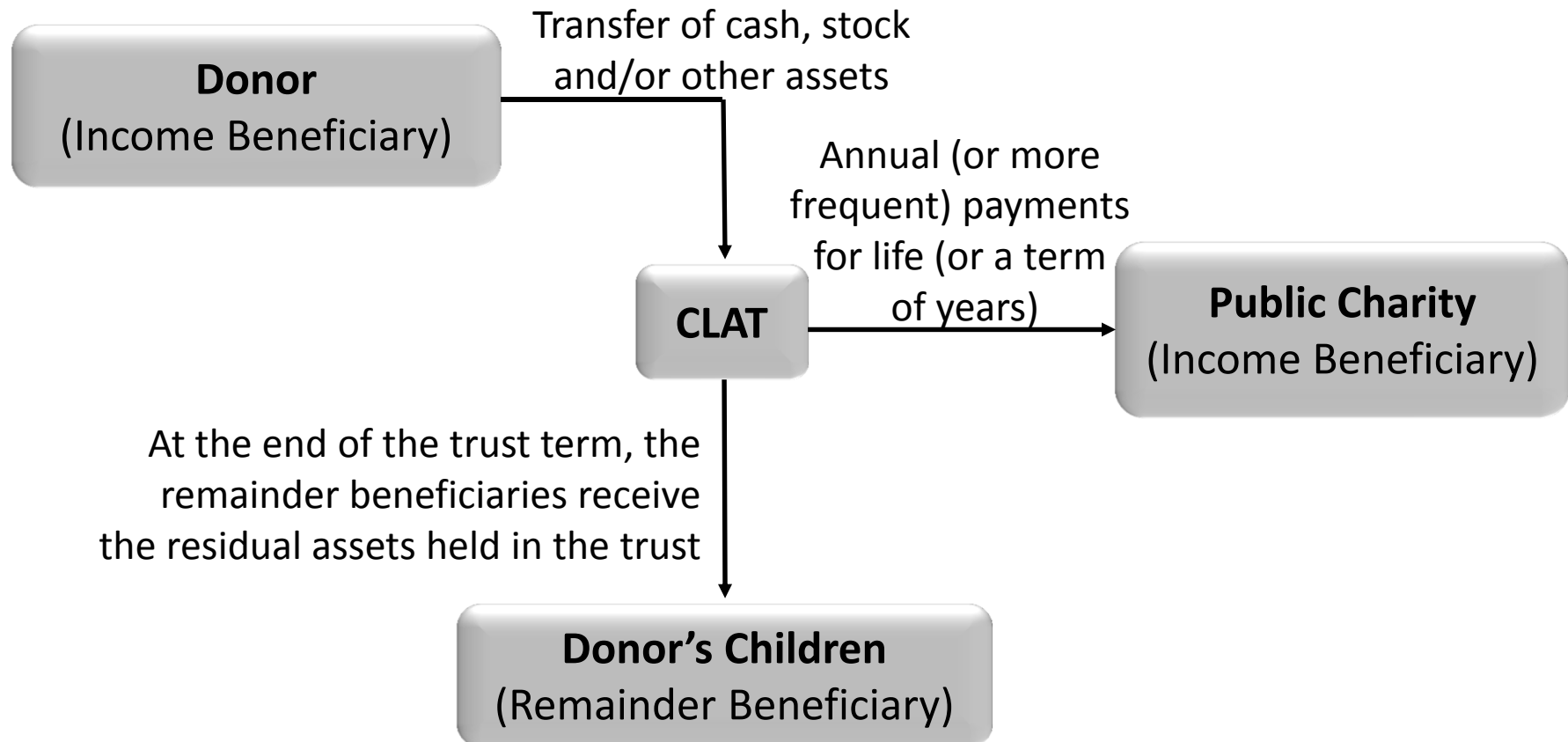
# #17 Inter Vivos CLAT

## *Overview*

- The charitable beneficiary receives a stated amount of the initial trust assets each year
  - The amount received is established at the beginning of the trust and will not change during the term of the trust regardless of investment performance (unless inadequate investment performance causes the trust to run out of assets)

# #17 Inter Vivos CLAT

## Overview



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# #17 Inter Vivos CLAT

## *Using the Charitable Deduction to Reduce the NIIT*

- Charitable deductions don't help individuals with the NIIT
- They don't reduce MAGI because they are below-the-line deductions taken on line 40 of Form 1040
- They don't reduce NII because only properly allocable deductions paid or incurred to produce the income can be deducted for NIIT purposes and the charitable deduction is not a cost of producing the income
- The income tax charitable deduction can be used to reduce the NIIT on charitable lead annuity trusts (CLTs), however



---

# #17 Inter Vivos CLAT

## *Using the Charitable Deduction to Reduce the NIIT*

- Strategy
  - CLAT receives an income tax charitable deduction under § 642(c) as annuity payments are made
  - Therefore, in effect, the CLAT is only subject to income tax on income in excess of the annuity payment amount
  - Additionally, it's an above-the-line deduction, so it can reduce the amount of NIIT and indirectly benefit the donor

# #17 Inter Vivos CLAT

## *Charitable Deduction and the 3.8% NIIT*

| <u>Individual IRC §170 Deduction</u>      |                  | <u>Trust - §642(c) Deduction</u> |             |
|---|------------------|----------------------------------|-------------|
| Wage Income                               | \$260,000        | Interest Income                  | \$100,000   |
| Interest Income                           | \$100,000        | Dividend Income                  | \$50,000    |
| Dividend Income                           | \$50,000         | MAGI                             | \$150,000   |
| MAGI                                      | \$410,000        | Less: Charitable Deduction       | (\$150,000) |
| Less: Threshold Exemption                 | (\$250,000)      | AGI                              | \$0         |
| Subtotal                                  | \$160,000        | NII Tax at 3.8%                  | \$0         |
| Lesser of Excess over<br>Threshold or NII | <b>\$150,000</b> |                                  |             |
| NII Tax at 3.8%                           | <b>\$5,700</b>   |                                  |             |

1) Does not reflect PEP, PEASE, or the charitable limitations

---

# #18 Grouping Business Activities to Create Material Participation

- How it works:
  - By grouping business activities to create material participation, the income or gains from the activities will not be considered passive
  - Net investment income does not include income or gains from non-passive activities
    - Thus, if the activity is non-passive and the activity is a trade or business, any income or gains will not be subject to NIIT
    - Caveat: Rental income is generally treated as NII even if a grouping election creates material participation for the taxpayer and the rental activity is a trade or business
- Fresh Start Provision
  - The proposed regulations for the NIIT allow taxpayers to regroup activities in the first year the taxpayer is subject to NIIT

---

# #19 Choice of Filing Status

- How it works:
  - If one spouse has most of the NII and the other spouse has most of the non-NII, filing separate returns may save significant amounts of NIIT
    - If the spouse with NII is below the \$125,000 threshold amount
  - It is also possible for NIIT to be payable if the spouses file separate returns but not payable if they file jointly
    - Filing jointly adds \$125,000 to the threshold amount for NIIT
- Caveat: The 0.9% Additional Medicare Tax on earned income must also be taken into account
  - The applicable threshold amounts are the same as for the 3.8% NIIT

---

# Section 6: Wealth Transfer Strategies

20. Intra-Family Loans

21. GRATs

22. Dynasty Trusts

23. IDGT Sale

24. Domestic Asset Protection Trusts

25. Spousal Limited Access Trusts

---

## #20 Intra-Family Loan(s)

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

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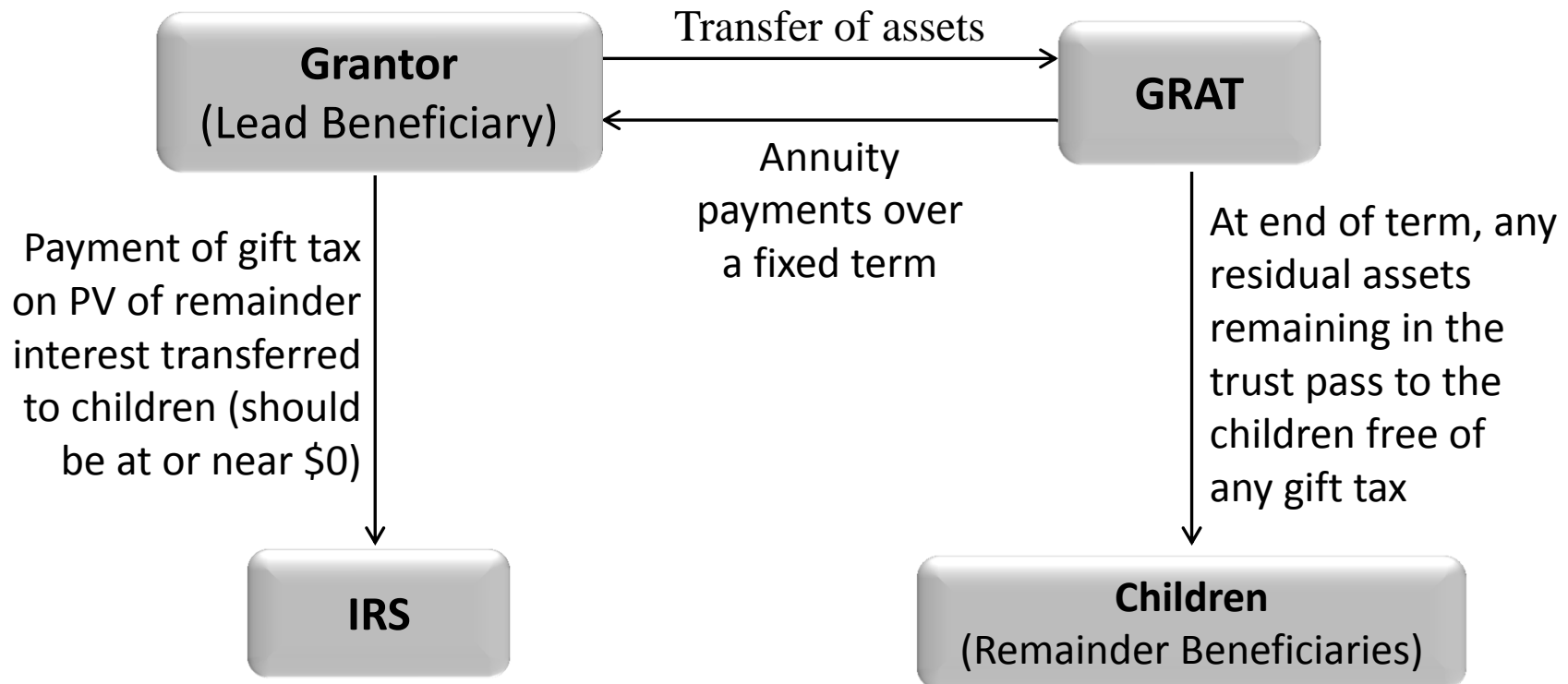
# #21 GRATs

## *Definition*

- 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

# #21 GRATs

## Overview





# #21 GRATs

## Example: 10-Year GRAT

| Year | Beginning Balance | Taxable Income<br>10.00% | Annuity Payment<br>\$ 747,025 | Ending Balance |
|------|-------------------|--------------------------|-------------------------------|----------------|
| 1    | \$ 10,000,000     | \$ 1,000,000             | \$ (747,025)                  | \$ 10,252,975  |
| 2    | \$ 10,252,975     | \$ 1,025,298             | \$ (747,025)                  | \$ 10,531,248  |
| 3    | \$ 10,531,248     | \$ 1,053,125             | \$ (747,025)                  | \$ 10,837,349  |
| 4    | \$ 10,837,349     | \$ 1,083,735             | \$ (747,025)                  | \$ 11,174,059  |
| 5    | \$ 11,174,059     | \$ 1,117,406             | \$ (747,025)                  | \$ 11,544,440  |
| 6    | \$ 11,544,440     | \$ 1,154,444             | \$ (747,025)                  | \$ 11,951,860  |
| 7    | \$ 11,951,860     | \$ 1,195,186             | \$ (747,025)                  | \$ 12,400,021  |
| 8    | \$ 12,400,021     | \$ 1,240,002             | \$ (747,025)                  | \$ 12,892,998  |
| 9    | \$ 12,892,998     | \$ 1,289,300             | \$ (747,025)                  | \$ 13,435,274  |
| 10   | \$ 13,435,274     | \$ 1,343,527             | \$ (747,025)                  | \$ 14,031,776  |

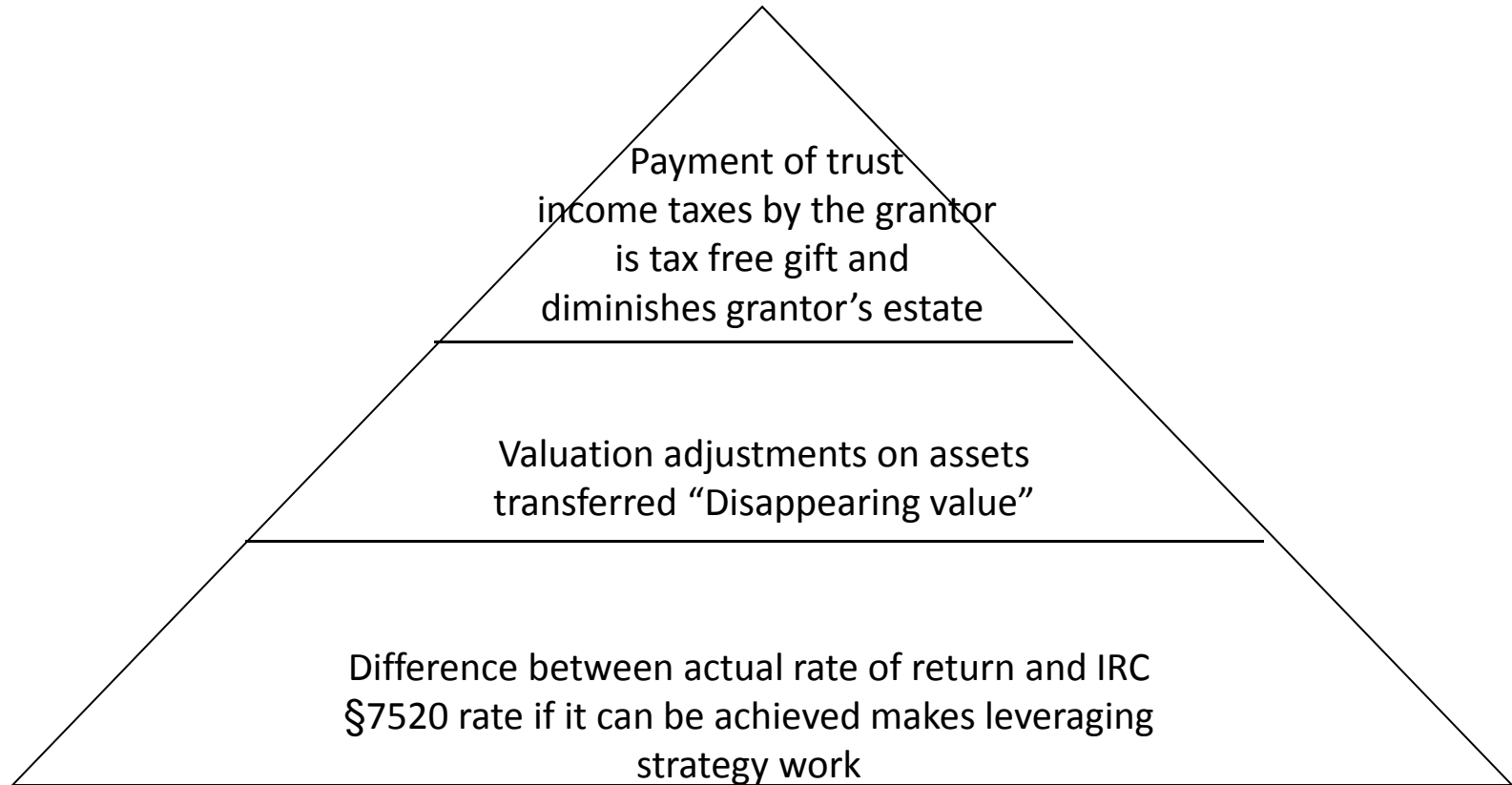
**Benefit: \$14,031,776 Transferred to Beneficiaries Tax-Free**

\* Assuming a \$7,000,000 (after valuation adjustments) initial contribution

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# #21 GRATs

## *Why GRATs Work*



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# #21 GRATs

## *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

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# #21 GRATs

## *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

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# #21 GRATs

## *Funding GRATs*

- “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

---

# #21 GRATs

## *Other GRAT 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

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# #22 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

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# #22 Dynasty Trusts

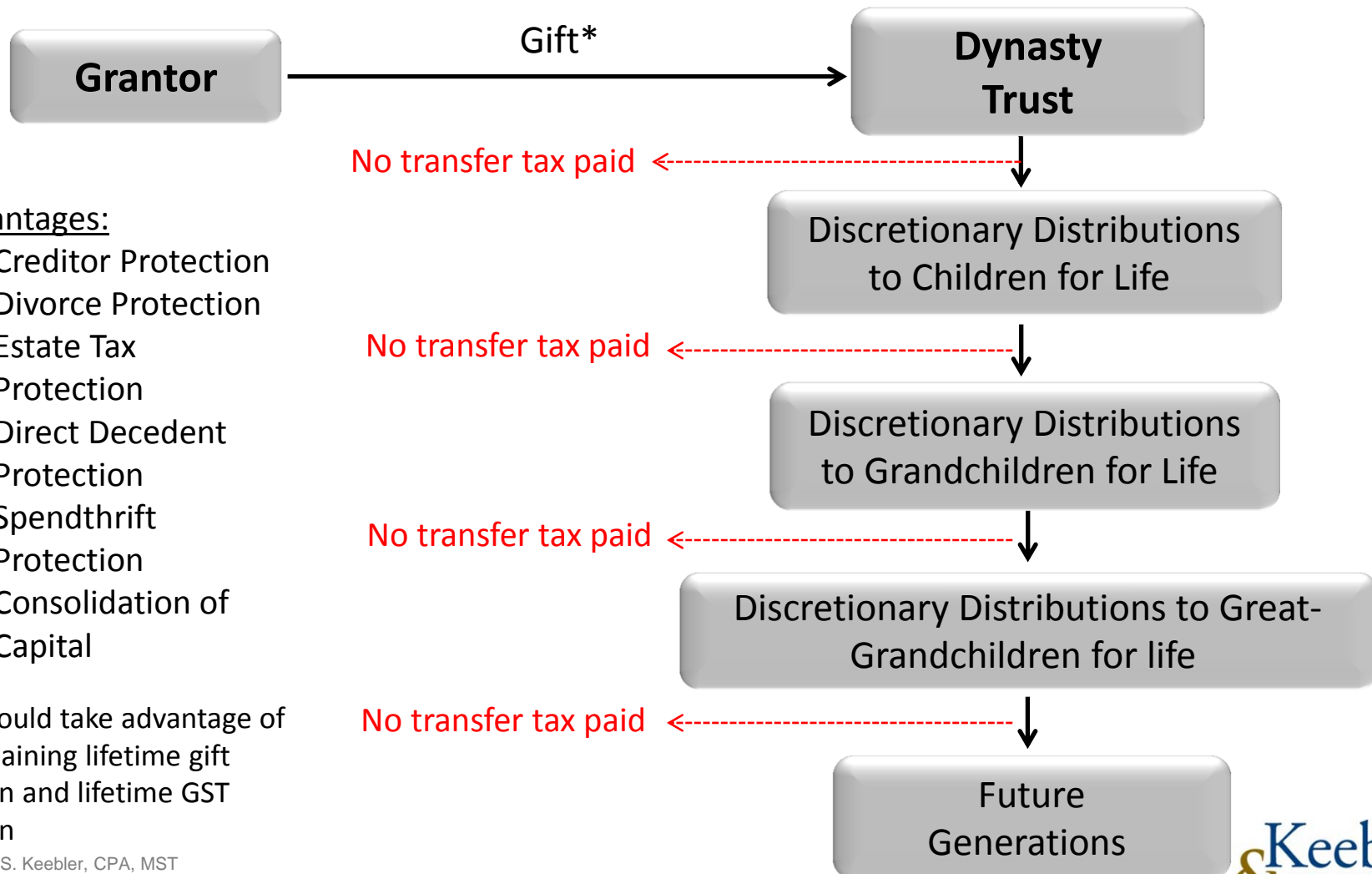
## *Strategy*

- 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



# #22 Dynasty Trusts

## Overview



### Advantages:

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

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

# #22 Dynasty Trusts

## *Tax Savings From Avoiding Estate Tax*

|                            | <u>5% Growth</u> | <u>7% Growth</u> | <u>9% Growth</u> |
|----------------------------|------------------|------------------|------------------|
| 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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# #22 Dynasty Trusts

## *Advantages*

- Takes maximum advantage of the \$5.25M (\$5.34M in 2014) lifetime gift tax exemption
- Takes maximum advantage of the \$5.25M (\$5.34M in 2014) 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

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# #23 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.

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# #23 IDGT Sale

## *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.

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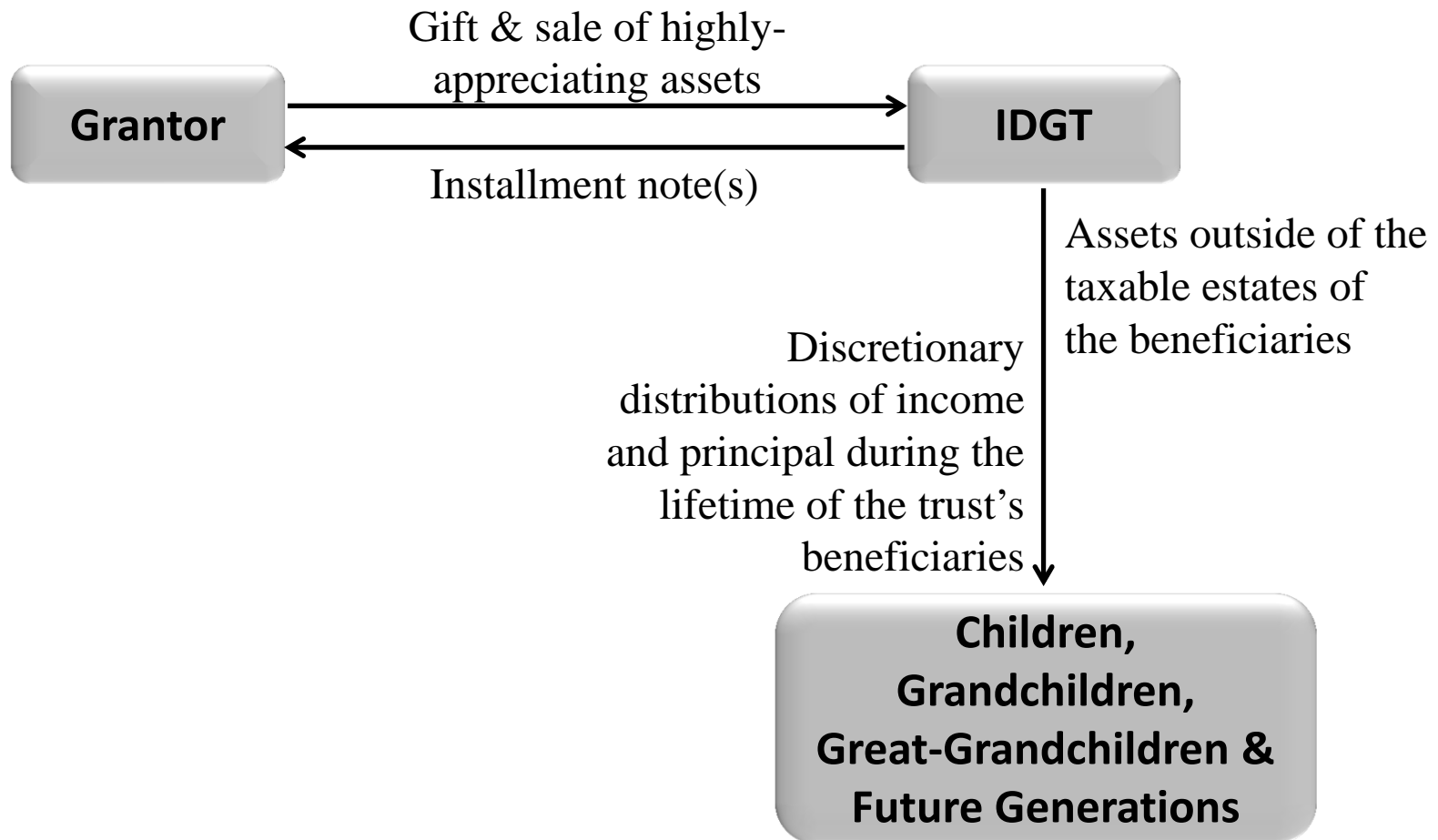
# #23 IDGT Sale

## *Overview (continued)*

- 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.

# #23 IDGT Sale

## Overview (continued)



# #23 IDGT Sale

*Current AFRs – January 2014*

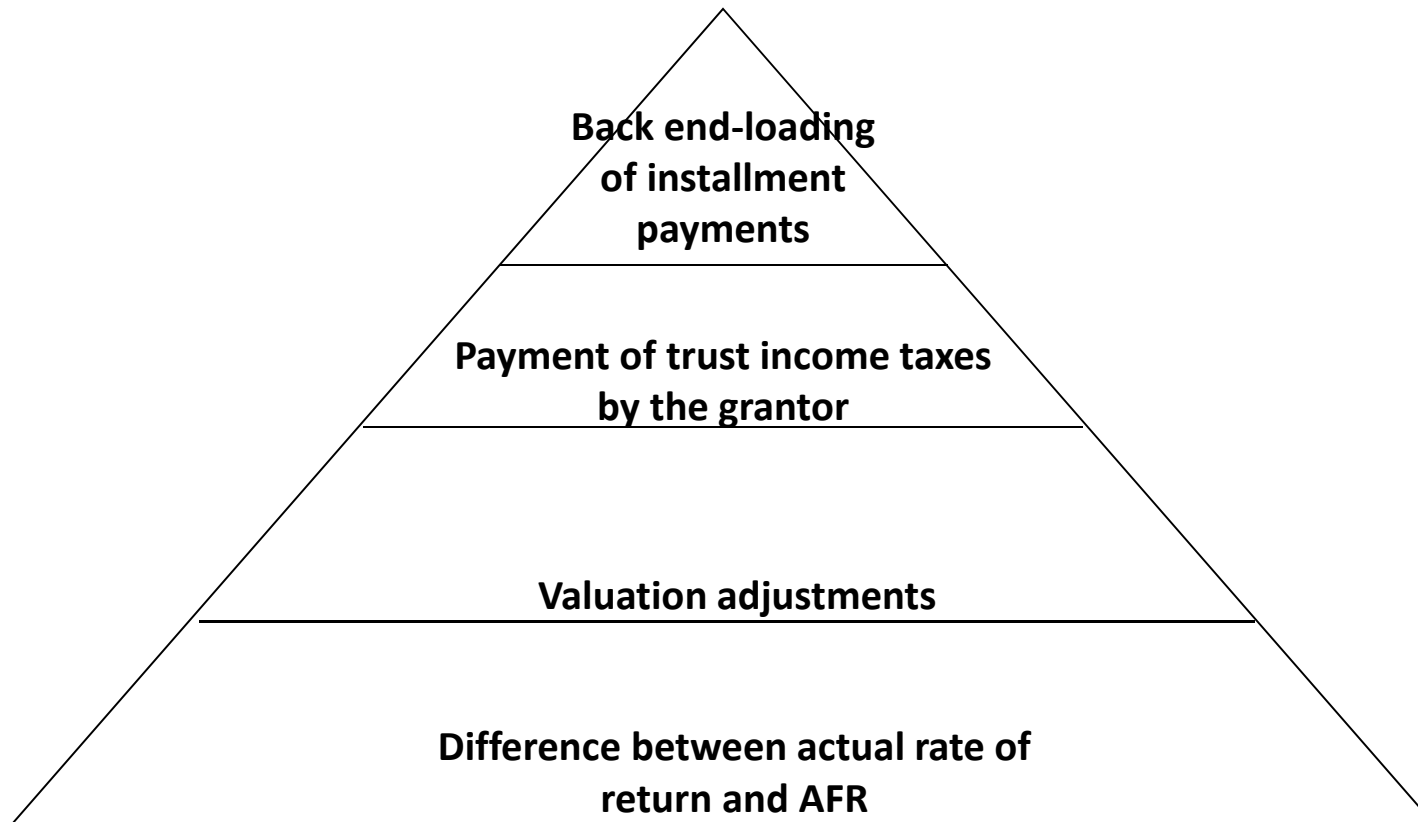
| Time Period                                | Rate  |
|--|-------|
| Short-term AFR (3 years or less)           | 0.25% |
| Mid-term AFR (over 3 years, up to 9 years) | 1.75% |
| Long-term AFR (over 9 years)               | 3.49% |



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# #23 IDGT Sale

## *Overview*



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# #23 IDGT Sale

## *Why an IDGT Sale Works - Summary*

|                                 |                                    |
|---------------------------------|------------------------------------|
| <b>Total Wealth Transferred</b> | <b><u><u>\$ 16,360,343</u></u></b> |
|---------------------------------|------------------------------------|

### *Reasons for Total Wealth Transferred*

|                               |              |
|-------------------------------|--------------|
| Difference in Rates of Return | \$ 5,525,213 |
|-------------------------------|--------------|

|                       |           |
|-----------------------|-----------|
| Valuation Adjustments | 4,104,463 |
|-----------------------|-----------|

|  |           |
|--|-----------|
| Payment of Trust Income Taxes by Grantor | 6,730,667 |
|--|-----------|

|                                 |                                    |
|---------------------------------|------------------------------------|
| <b>Total Wealth Transferred</b> | <b><u><u>\$ 16,360,343</u></u></b> |
|---------------------------------|------------------------------------|

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# #23 IDGT Sale

## *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

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# #23 IDGT Sale

## *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)

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# #24 Domestic Asset Protection Trust(s)

- How it works:
  - Created in a state that has a law allowing self-settled spendthrift trusts
  - The trust is irrevocable
  - Trustee has absolute discretion to make distributions to the settlor
  - The trust includes a spendthrift clause prohibiting payments to most of the settlor's creditors
  - The trustee is independent of the settlor and a resident of the selected DAPT state
  - Some or all of the trust assets must be located in the DAPT state
  - Certain special creditors can reach the trust assets
- Enables taxpayers to give away assets and remove future appreciation from their estate while retaining the benefit of the assets if need

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## #25: Spousal Limited Access Trust(s)

- An irrevocable trust established by one spouse for the benefit of the other spouse, with the remainder interest passing to the couple's children
- How it works:
  - 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
- Caveat: Reciprocal Trust Doctrine
  - If both spouses set up a SLAT for the benefit of the other
  - Make the SLATs sufficiently different from each other

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# Questions?

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# Thank You!



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# Contact

- For information on upcoming seminars and webinars, please visit our website:

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