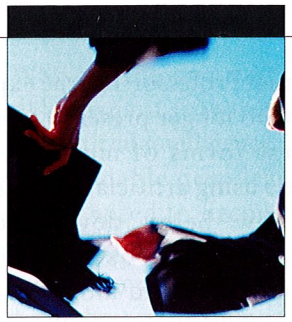

High Returns and Tax-Free Compounding: Keys to Building Wealth

Although the vehicles for growing significant estates are varied and frequently evolving, some enduring principles are widely applicable for advising clients.

JEFF GLICKMAN AND JONATHAN G. BLATTMACHR

Many individuals (and trusts for their benefit) wish to build wealth to a significant level. In order to accomplish that, individuals usually need to invest for high returns and minimize income tax erosion of those returns.[1] This article briefly discusses approaches, including a new methodology, to increase investment returns. It then explores how taxation erodes higher returns more than lower returns. Moreover, it presents ways by which the income taxation of returns may be eliminated or reduced. As the article details, for some individuals, tax-free compounding may be a critical factor in building wealth.

Searching for high returns

Seeking to reduce or avoid income tax is sensible only if there is positive taxable income or gain. As is discussed below, in order to build significant wealth through investments and try to avoid or reduce income taxation on the investment income or gain, the returns need to be more than de minimis. Tax reduction or even tax avoidance alone will not convert paltry returns into significantly greater wealth. Indeed, as explained below, the higher the return, the more important the reduction or avoidance of income tax becomes. Ideally, an investor probably should seek high returns with low or no income tax.

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But the first goal is to obtain high returns and then compare these anticipated returns to likely after-tax results, taking into account risk and consistency.

The average individual investor reportedly earns only about 2.5% a year even over long terms,[2] despite reasonable and somewhat conservative investments in equities typically producing much higher returns than that.[3] So, in order to build wealth through investments, taxpayers must thoughtfully approach how they invest.

With so many categories of investments and so many ways to categorize them, generalizations are difficult to make. Even though historically equities have produced greater returns than have fixed-income investments,[4] and hedge funds[5] have been reported to outperform equities,[6] such broad generalizations may not be an appropriate investment strategy to secure high returns. Even if an investor decides to invest exclusively in

hedge funds or equities to seek high returns, decisions must be made as to which equities and which hedge funds to acquire and hold. In any case, hedge funds—including quantitative investments[7]—tend to produce, in an income tax sense, ordinary income and short-term gains, all of which are subject, as a general rule, to the highest levels of income tax.

Different managers or advisors use different approaches to acquire and enhance yield. Some have been extremely successful. For example, mathematician and hedge fund manager Edward O. Thorpe, who developed a winning card counting strategy for playing blackjack (a/k/a 21), enhanced returns in public markets using mathematics to "exploit" certain market anomalies or inefficiencies, allegedly allowing him to cause "his personal investments [to] yield ... an annualized 20 percent rate of return averaged over 28.5 years."[8] It is understood that the market anomalies that Professor Thorpe exploited are no longer present.[9] However, new forms of mathematical models using artificial intelligence are now being developed to enhance returns as the markets become more and more efficient (that is, eliminate anomalies or inefficiencies).

There have been three basic generations of investment methodologies:

1. Value investing, where investments are made in companies that are priced below their value. Value investing has been defined as "[t]he strategy of selecting stocks that trade for less than their intrinsic values. Value investors actively seek stocks of companies that they believe the market has undervalued. They believe the market overreacts to good and bad news, resulting in stock price movements that do not correspond with the company's long-term fundamentals. The result is an opportunity for value investors to profit by buying when the price is deflated."[10]
2. Technical analysis, where investments are purchased and sold based on patterns in price and volume. More specifically, "technical analysis is a security analysis methodology for forecasting the direction of prices through the study of past market data, primarily price and volume. Behavioral economics and quantitative analysis use many of the same tools of technical analysis, which, being an aspect of active management, stands in contradiction to much of modern portfolio theory."[11]
3. Algorithmic trading, where investments are made using the power and speed of computers to exploit price differences.

Over time, and with each succeeding generation, the opportunity to profit in public investment markets has eroded. Today, the most

1 Some individuals, such as certain celebrities, build wealth through their personal (non-investment) earnings. These individuals also will build more wealth by avoiding income tax on those personal earnings. The ways discussed in this article to avoid or reduce income tax on investment earnings generally cannot be used to avoid or reduce income tax on personal earnings.

2 Hanlon, "Why the Average Investor's Investment Return Is So Low," Forbes, 4/24/2014, available at www.forbes.com/sites/advisor/2014/04/24/why-the-average-investors-investment-return-is-so-low/#2715e4857a0b3eaa633563a4 (last visited on 2/10/2016).

3 Dunn, "What Rate of Return Should You Expect to Earn on Your Investments," Pete the Planner Blog, 1/18/2013, available at http://blog.petetheplanner.com/what-rate-of-return-should-you-expect-on-your-investments/#sthash.iuoet2ED.dpbs (last visited on 2/10/2016).

4 Damodaran, "Annual Returns on Stock, T. Bonds and T. Bills: 1928—Current," last updated 1/5/2016, available at http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html (last visited on 2/10/2016).

5 The term "hedge fund" seems to lack a fixed or definite definition. Investopedia offers this explanation: "Hedge funds are alternative investments using pooled funds that may use a number of different strategies in order to earn active return, or alpha, for their investors." www.investopedia.com/terms/h/hedgefund.asp (last visited on 2/10/2016).

6 KPMG International, "The Value of the Hedge Fund Industry to Investors, Markets, and the Broader Economy" (2012), available at www.kpmg.com/KY/en/Documents/the-value-of-the-hedge-fund-industry-part-1.pdf (last visited on 2/10/2016). This report concluded, using the HFR equal-weighted index and strategy indices, that the returns for hedge funds considered from 1994-2011 was a gross annual return 12.61% and a net return (after fees, but before taxes) was 9.07%.

7 "Quantitative investing represents an investing technique typically employed by the most sophisticated, technically advanced hedge funds. These firms employ fast computers to find predictable patterns within financial data." https://en.wikipedia.org/wiki/Quantitative_investing (last visited on 2/10/2016).

8 https://en.wikipedia.org/wiki/Edward_O._Thorp (last visited on 2/10/2016).

9 Cf. Lowenstein, *When Genius Failed: The Rise and Fall of Long Term Capital Management* (Random House, 2000).

10 www.investopedia.com/terms/v/valueinvesting.asp (last visited on 2/10/2016).

11 https://en.wikipedia.org/wiki/Technical_analysis (last visited on 2/10/2016).

12 Phillips, "Warren Buffett: 'We're Having a Hard Time Finding Things to Buy,'" Quartz website, 9/20/2013, http://qz.com/126527/warren-buffett-were-having-a-hard-time-finding-things-to-buy/ (last visited on 2/10/2016).

13 "The black swan theory or theory of black swan events is a metaphor that describes an event that comes as a surprise, has a major effect, and is often inappropriately rationalized after the fact with the benefit of hindsight." https://en.wikipedia.org/wiki/Black_swan_theory (last visited on 2/10/2016).

14 "Quantitative investing represents an investing technique typically employed by the most sophisticated, technically advanced hedge funds. These firms employ fast computers to find predictable patterns within financial data. *** Typically, quant investing is implemented by people who have spent time in the physics, math, computer science, or statistics disciplines. *** The process consists of thorough examination of vast databases searching for repeating patterns—persistent occurrences of a phenomenon, correlations among liquid assets ('statistical arbitrage' or 'pairs trading'), or price-movement patterns (trend following or mean reversion)." https://en.wikipedia.org/wiki/Quantitative_investing (last visited on 2/10/2016).

15 The definition of artificial or machine intelligence is not a clear one. See https://en.wikipedia.org/wiki/Artificial_intelligence (last visited on 2/10/2016). To date, it seems, with the possible exception of systems like IBM's Watson, the computer follows instructions built by humans. It has no choice but to follow those. But "true" artificial intelligence of the type envisioned by Ray Kurzweil and others involves the computer "thinking" in a manner similar to how humans do but with much greater speed and power—essentially, a computer that thinks for itself.

16 See, e.g., Kurzweil, *The Age of Spiritual Machines: When Computers Exceed Human Intelligence* (Penguin Books, 1999).

seasoned and experienced investors are having difficulty identifying investment opportunities. Even Warren Buffett has been quoted as saying "We're having a hard time finding things to buy."[12] Throw in market crashes, black swans[13] and high volatility, and the result is the perfect investing storm. The opportunities have eroded because markets have become more efficient so finding inefficiencies is much more challenging. And that makes the markets appear more random and, therefore, unpredictable.

However, patterns sometimes can be found in what appears to be randomness. For example, storms have patterns, such as in a line of thunderstorms and in the round circulating structure of a hurricane. Comparable patterns exist in the markets even when they are complicated by simultaneous value, technical, and algorithmic trading. Find the pattern in the investment storm, and new and unexpected opportunities arise in the public trading market. Yet, finding these patterns in this market is far beyond the reach of the algorithmic and quantitative trading.[14] And it seems far beyond the reach of human cognitive abilities.

Consider, however, the most advanced artificial intelligence ever constructed, running on a supercomputer as large and as fast as IBM Watson, the computer that beat all humans at Jeopardy. Consider an artificial intelligence applying its formidable deep learning, power, and speed to deconstructing market patterns. Now consider the intelligence's ability to surpass the highest performing funds, even greater than Thorpe's when markets contained many inefficiencies. Consider that intelligence's ability to forecast market direction better than any human even when aided with the most powerful computer assistance available.

This is now occurring and it represents the fourth generation of investing: artificial intelligence investing.[15] After all, it has been forecasted for more than 15 years that a time would come when computer intelligence would exceed human intelligence.[16] That time seems to have now arrived.

First there was the Industrial Revolution. Then the Information Revolution upon which quantitative investing (using complex algorithms) has been based. And today we stand on the threshold of the Artificial Intelligence Revolution.

So, if returns even beyond the consistent 20% average annual returns Professor Thorpe experienced can be achieved using new technology, will those returns be significantly eroded by income tax? The answer is likely yes because the gains likely will be short term as they typically are using quantitative trading. However, before discussing how to reduce or eliminate the tax on high returns, it is appropriate to explore how important the compounding of the high returns may be in building wealth.

Importance of Compounding

Albert Einstein, who was labeled by Time magazine as the most important person of the 20th century,[17] changed the vision of the universe. His theories have largely been verified empirically, which some of us can readily grasp, but very few of us can comprehend the mathematics he used to prove his propositions.[18]

However, he allegedly made two statements that virtually everyone can understand:

New forms of mathematical models using artificial intelligence are now being developed to enhance returns as the markets become more and more efficient.

1. Compounding is the most powerful force in the universe (or compound interest is humanity's greatest invention).[19]
2. The hardest thing in the world to understand is the income tax.[20]

The corollary we derive from those two Einstein "theorems" is that the most important thing in financial planning is tax-free compounding. And the mathematics, as explained below, support the accuracy of the corollary. But first we turn to Professor Einstein's first theorem: the importance of compounding. Consider some examples.

Example 1. If one invests $100 and it earns 5% a year ($5 annually), the investment will grow, without compounding, to $150 in ten years and to $300 in 40 years. With annual compounding, it will grow to $162 in ten years and to $704 in 40 years. The increase in wealth with yearly compounding at a 5% annual return for ten years is only 8% greater than without compounding, which might indicate that compounding is not that important. However, over 40 years, compounding annually on a

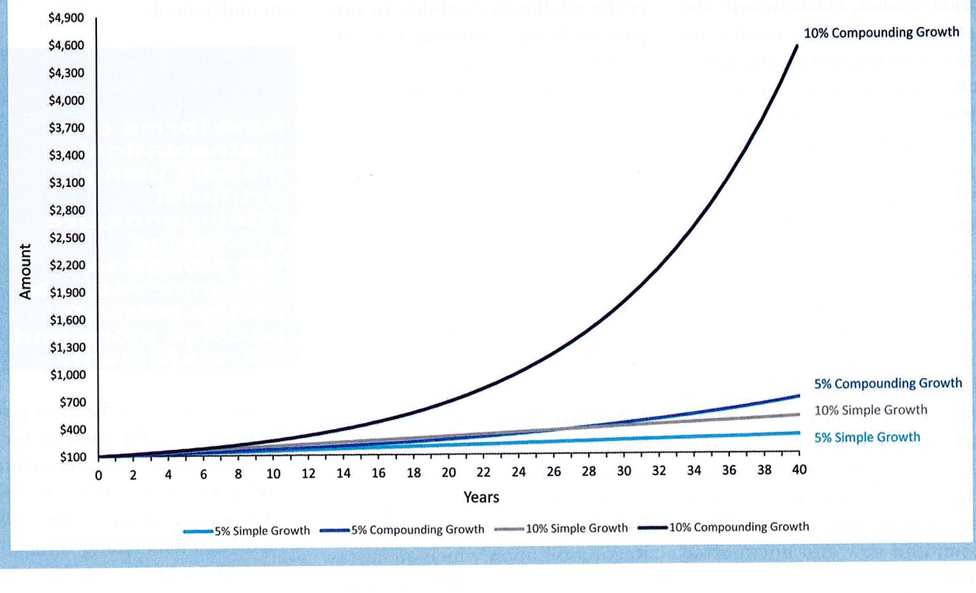
17 Golden, "Albert Einstein," Time Magazine Person of the Century issue, 12/31/1999, available at http://content.time.com/time/magazine/article/0,9171,993017,00.html (last visited on 2/10/2016).

18 https://en.wikipedia.org/wiki/Tests_of_general_relativity (last visited on 2/10/2016). It has recently been determined that Professor Einstein may have been wrong in at least one of his views. See Markoff, "Sorry, Einstein. Quantum Study Suggests 'Spooky Action' Is Real" NY Times 10/21/2015, available at http://www.nytimes.com/2015/10/22/science/quantum-theory-experiment-said-to-prove-spooky-interactions.html?_r=0 (last visited on 2/10/2016).

19 www.snopes.com/quotes/einstein/interest.asp (last visited on 2/10/2016).

20 http://quoteinvestigator.com/2011/03/07/einstein-income-taxes/ (last visited on 2/10/2016).

EXHIBIT 1
Simple vs. Compounding Return



5% annual return produces a return of about 230% (or 2.3 times) more than without compounding. It is obvious that the difference in the level of wealth with a positive return that compounds compared to one that does not compound is profound.

The effect of compounding is more pronounced if the annual return increases.

Example 2. The facts are the same as in Example 1, except the annual investment return is 10%. In that event, the $100 will grow, without compounding, to $200 in ten years and to $500 in 40 years. With annual compounding with a 10% yearly return, the $100 grows to $259 in ten years which is a 29.5% increase. And after 40 years, compounding once a year with a 10% annual return produces a balance of $4,500. That is nine times more than without compounding.

The lessons we derive are (1) the longer the term, the greater the effect of compounding, and (2) the higher the annual return, the greater the relative increase in wealth from compounding. This concept is illustrated in Exhibit 1.

Impact of income taxation on returns

The impact of income taxation on returns also can have a profound effect on the accumulation of wealth. For example, looking at various yearly compounded returns over a 17-year term, the effect of the current income taxation can be readily discerned:

1. At a 6% annually compounded return, each dollar grows to $2.69 without taxation but only to $2.22 with a 20% annual income tax or, in other words, a 17% reduction in wealth at the end of the term.
2. At a 10% annually compounded return, each dollar grows to $5.05 without taxation but only to $3.70 with a 20% annual income tax or, in other words, a 27% reduction in wealth at the end of the term.
3. At a 20% annually compounded return, each dollar grows to $22.19 without taxation or $12.47 with a 20% annual income tax or, in other words, a 44% reduction in wealth at the end of the term.
4. At a 30% annually compounded return, each dollar grows to $86.50 without taxation or $38.74 with a 20% annual income tax or, in other words, a 55% reduction in wealth at the end of the term.
5. At a 40% annually compounded return, each dollar grows to $304 without taxation or $112.14 with a 20% annual income tax or, in other words, a 63% reduction in wealth at the end of the term.

Now consider the effect of a higher annual income tax. For example, again over a 17-year term:

1. At a 6% annually compounded return, each dollar grows to $2.69 without taxation but only to $1.82 with a 40% annual income tax or, in other words, a 32% reduction in wealth at the end of the term.
2. At a 10% annually compounded return, each dollar grows to $5.05 without taxation but only to $2.69 with a 40% annual income tax or, in other words, a 47% reduction in wealth at the end of the term.
3. At a 20% annually compounded return, each dollar grows to $22.19 without taxation or $6.87 with a 40% annual income tax or, in other words, a 68% reduction in wealth at the end of the term.
4. At a 30% annually compounded return, each dollar grows to $86.50 without taxation or $16.67 with a 40% annual income tax or, in other words, an 80% reduction in wealth at the end of the term.
5. At a 40% annually compounded return, each dollar grows to $304 without taxation or $38.74 with a 40% annual income tax or, in other words, an 87% reduction in wealth at the end of the term.

The lessons to be derived from this are, as illustrated in Exhibit 2:

- The higher the effective rate of annual taxation, the greater the erosion of wealth.
- The higher the return, the more the return is eroded by current income tax.

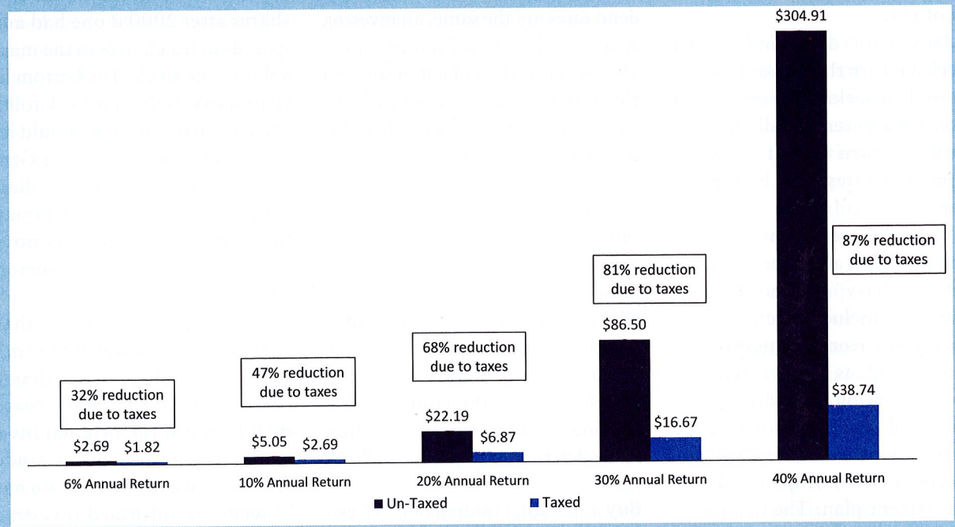
Trusts may face even higher taxes than individuals because, among other things, they face the highest rate of federal income tax and become subject to the net investment income tax at much lower thresholds of income than do individuals.[21]

Reduce or avoid tax erosion

The foregoing suggests that a compelling case can be made that avoiding income taxation of returns, especially high returns, is an impor-

[21] Cf. Sections 1(a), (b), (c), and (d) with (e). See also Sections 1411(a)(1) and (2). As a general rule, a trust is taxed the same as is an individual. See Section 641(a). The income of certain trusts, commonly called "grantor trusts," may be attributed to their grantors or another (or others) as though the trust did not exist. See Section 671. Unless otherwise indicated, throughout this article the word "trust" refers to a trust that is not a grantor trust whose income is attributed directly to the trust's grantor (or another) under Section 671.

EXHIBIT 2
The Effects of Taxation on Compounded Returns After 17 Years



tant goal in wealth accumulation. Obviously, the two issues are how to achieve high returns, which was briefly discussed above, and how to avoid the tax on the profits. Now consider the avoidance or reduction of tax.

Many factors determine whether to seek a return that is not taxed as opposed to seeking a return that is taxed at a lower overall rate than another return would. The top income tax rates vary by type of income:

1. Taxable interest, short-term capital gain, and other forms of "ordinary" income. This category includes such items as income from business operations and, as a general rule, compensation, including deferred compensation paid from an individual retirement account (IRA) or qualified retirement plan. The income may be taxed at a top federal rate of 39.6% under Section 1 and may be further taxed (but not with respect to distributions from an IRA or qualified retirement plan, or from certain business profit where the taxpayer is actively involved) with the additional 3.8% net investment income tax under Section 1411, bringing the total to 43.4%.
2. Long-term capital gain and qualified dividends. This income may be taxed at a top rate of 20% and may be subject to the additional 3.8% net investment income tax, bringing the total to 23.8%.

Lower taxed returns. One aspect, therefore, of an investment strategy to reduce the erosion of returns by income tax is to choose investments where the effective tax rate on earnings (or growth) is lower than on other investments. For example, interest paid on a corporate bond may be subject to a federal tax of 43.4% while a qualified dividend paid by the same company will be subject to a federal tax of no more than 23.8%. Hence, if the interest and dividend rates are the same, an investor, who is subject to income tax,[22] almost certainly will net more (and thereby have an opportunity to experience greater wealth accumulation) by receiving dividends rather than interest.

The comparison is more complicated for several reasons including that, as a general rule, the interest must be paid (almost always annually) and the debt obligation paid as provided in the debt instrument. In contrast, dividends usually are payable only if the company has earnings and the company voluntarily determines to pay a dividend.

Buy and hold. Holding onto investments too long is listed by Raymond Jones as accounting for 11% of the most detrimental investor mistakes.[23] Nonetheless, whether it is best to "buy and hold" and, if so, for how long, has been "hotly" debated.[24] One related story, which might be apocryphal, is about John Pierpont Morgan. It is claimed that, at breakfast each morning, Morgan would have his butler bring him the list of securities he owned. If there were any he would not buy that day, he would sell it (or them). Another way to look at it is to ask yourself whether you would buy a particular security you currently own if you then held cash equal to its value instead of the stock. If the answer is that you would not then use the cash to buy it, it should be sold. So why would an investor buy and hold instead of discarding what is perceived to be a less attractive investment than another that is available?

Consider the market prices of Microsoft stock (MSFT) one of the most storied publicly traded shares. Coming out in 1986 at seven cents a share,[25] it soared over 500 fold by early 2000. Then it dropped and stayed essentially flat for nearly 15 years.[26] It probably would have been unwise to stay with those shares after 2000 if one had anticipated such a change in the market value of the stock. The bottom line, so to speak, is that no stock follows the same pattern. Who would have believed ten years ago that General Motors would go into bankruptcy? Arguably, a true buy-and-hold-forever strategy is not an investment strategy; it is merely a default mode.

One response might be that it is impossible to know if the "new" investment will be better than the current one. If that is the reason, then how did the original investment come about? Just a random selection? Random selection hardly seems an informed investment decision. Another response is that the cost of getting rid of the current investment and acquiring a new one is just too great. But with the plethora of discount brokers available, the transaction costs probably should not be viewed as a significant deterrent to dropping

22 Many investors, including most charitable organizations described in Section 501(c)(3), are not usually subject to income tax on investment income.

23 Raymond James, "Long-Term Investment Performance," 3/1/2011, page 25, available at http://www.raymondjames.com/melvillewealthmanagement/pdfs/Long_Term_Investment_Performance.pdf (last visited on 2/10/2016).

24 Compare Jaffe, "Buy-and-Hold Is Impossible," MarketWatch.com, 7/25/2014, available at www.marketwatch.com/story/buy-and-hold-is-impossible-2014-07-25 (last visited on 2/10/2016), with InvestorGuide Staff, "Why Buy and Hold Stock Strategy is Good for Long-Term Investment," investorguide.com, available at www.investorguide.com/article/11783/why-buy-and-hold-stock-strategy-is-good-for-long-term-investment-igu/ (last visited on 2/10/2016).

25 This price has been adjusted to reflect stock splits, etc. to date.

26 See Yahoo! Finance website at http://finance.yahoo.com/q/hp?s=MSFT&a=02&b=13&c=1986&d=09&e=14&f=2015&g=m&z=66&y=0 (last visited on 2/10/2016).

27 Section 1014(a).

28 See Section 72.

what is perceived to be a less attractive publicly traded stock (or similarly publicly available) investment in favor of a better one. Perhaps, the most common reason is that tax will have to be paid on the disposition of the current investment that has appreciated in value. As demonstrated above, tax reduces wealth. If the inherent tax is a meaningful component of the value of the current investment, then the substituted investment has to produce much more to "catch up" to and then exceed the value of the current investment.

Hence, a rational conclusion is that investors should not buy and hold investments when more attractive ones are available if the tax may be avoided in making the conversion to the other investments. Buying and holding may avoid tax and, as has been just stated, tax may retard returns compared to what the return would be if different investments could be made (without any or without significant taxation).

One advantage of a "permanent" buy and hold strategy is that, to the extent the investment is held until death, the inherent gain usually is forgiven for income tax purposes as the basis of the assets is "stepped" up to date-of-death fair market value.[27] Even a long-term but not permanent buy-and-hold strategy (i.e., postponing the recognition of gain for several years) usually will reduce the effective annualized rate of taxation but not eliminate it.

Example. A security purchased for $100 that appreciates at 10% a year for ten years will grow to be then worth $259; if sold at that time with the $159 profit subject to a 23.8% capital gains tax, $221 will remain after tax. However, if the stock is sold each year to capture the 10% annual growth and exposed to a 23.8% income tax and reinvested, the value will grow to only $208 in ten years or about 6% less than if the gains tax was postponed for ten years. The longer the recognition of gain is postponed, the greater the wealth that may be accumulated, all other things being equal. But, of course, things are almost certainly not going to be equal.

One additional factor of a buy-and-hold strategy may preclude complete tax postponement: current income from the asset (e.g., dividends paid on stock) generally is subject to income taxation as received. Some assets, such as raw land that is not rented, may produce no current income but many investment do produce current income even if purchased primarily for appreciation that will not be taxed until the disposition of the investment (and not at all if held until death).

Municipal bonds. Some investors believe that municipal bonds are tax free. They really are not. They are, in effect, pre-taxed by the government that issues them in a manner similar to an employee's compensation that is subjected to withholding tax. The return, for some investors, on such bonds is greater than what a comparable taxable bond would be after the income tax on the bond's interest is paid, as such interest likely will be subject to the highest income tax rates under federal law (up to 43.8%).

Annuities. Certain annuities provide income tax deferral until the earnings realized in the annuity are recognized for income tax purposes which almost always will be no later than when distributions are taken from the annuity contract.[28] All distributions of earnings or profits are treated as ordinary income (subject to the highest rate of income tax) even if the profits

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are attributable to realization of capital gain or even tax-exempt receipts. However, tax deferral can be significant, especially over a long time. And investments generally may be changed (subject to choices offered by the "manager" of the annuity), without income tax, inside the annuity arrangement. The owner of the annuity, however, cannot make the direct investment decisions (e.g., to sell Stock X and buy Stock Y), according to the IRS, or the tax deferral will be lost.[29] Unlike most other investments, the inherent profit or gain in an annuity contract is not "forgiven" at the death of the owner.[30]

Trusts generally cannot hold an income-tax-deferred annuity, as such a holding is restricted to human beings.[31]

IRAs and qualified retirement plans. Individual retirement accounts[32] (IRAs) and qualified retirement plans[33] provide income tax deferral (except for unrelated business taxable income, which is currently taxed[34]) of the income earned in such vehicles. However, as with annuities, all distributions, as a general rule, are taxed at the highest rate of income tax.[35] In addition, as a practical matter, deferral is limited as distributions usually must commence around age 71 years or severe penalties are imposed.[36] And, as with an annuity, the income tax liability inherent in the profit embedded in the IRA of a qualified retirement plan is not eliminated at death.

IRAs and qualified retirement plans, however, may offer a further benefit: the contributions to the arrangement often are, in effect, income tax deductible, up to the limits provide by the Internal Revenue Code.[37] This provides a larger base on which earnings may occur.

A taxpayer, as a general rule, may "convert" an IRA (commonly called a "traditional" IRA) or interest in a qualified retirement plan into a Roth IRA.[38] Just as with a traditional IRA, income usually grows income tax free inside a Roth IRA. But unlike a traditional one, distributions from a Roth IRA usually are not included in gross income, and distributions need not be taken by the Roth IRA owner (or his or her spouse if the spouse succeeds to the ownership of the account) upon attaining around age 71 in order to avoid penalties. However, as a general matter, the conversion causes the entire amount in the traditional IRA or plan to be included in gross income. The resulting income tax may be paid from cash other than that inside the plan or IRA. All other things being equal, that produces an opportunity for greater wealth accumulation than investing the cash held outside the plan or IRA and not doing the conversion.

It is nearly axiomatic that the most efficient estate tax planning occurs by lifetime transfers. Thus, one potentially adverse effect of an IRA (including a Roth IRA) or qualified retirement plan is the inability to engage in this sort of planning that would reduce the estate tax due when the owner of the IRA or plan participant with respect to the plan dies. In the opinion of at least one commentator, any transfer during lifetime of an IRA or plan, even to an entity that is disregarded for income tax purposes, causes the vehicle to lose its tax-exempt status.[39]

Estate tax (or other wealth transfer tax, such as gift tax) can be a significant "eroder" of wealth. That, coupled with the continuation of inherent income tax liability in an IRA or plan, means that a significant portion of the vehicle will be eroded. The combined federal and state death and income taxes, in some cases, could exceed 90% of the amount in the IRA or qualified plan.

Example. In the state of Washington, the highest state estate tax rate is 19%. (In many other jurisdictions that impose a state death tax, it is 16%.) State death taxes imposed on property included in the federal gross estate are deductible, under Section 2058, for purposes of determining the federal taxable estate. Thus, for example, where the state rate is 19%, only 81% of what otherwise would be the taxable estate is exposed to the 40% federal estate tax rate. The effective federal estate tax rate is, therefore, 40% of 81%, or 36.4 %. When that is added to a 19% state estate tax, the combined effective estate tax rate is 55.4%.

The 36.4% federal estate tax rate is deductible, pursuant to Section 691(c), for purposes of determining the amount that is subject to income tax. Section 68 could reduce the deduction allowed by Section 691(c) by 80%, meaning that of the 36.4% effective federal tax only 20% of it or 7.28% is deductible.

29 See Rev. Rul. 77-85, 1977-1 CB 12; Rev. Rul. 2003-91, 2003-2 CB 347; cf. Webber, 144 TC No. 17 (2015).

30 Section 691(a).

31 See Section 72(u) but see Kitces, "Owning Deferred Annuities In Trusts and Preserving Tax-Deferral Treatment," Nerd's Eye View at Kitces.com, 12/25/2013, available at www.kitces.com/blog/trust-ownership-of-deferred-annuities/ (last visited on 2/10/2016).

32 See Section 408.

33 See Section 401.

34 See Section 511.

35 However, such distributions are not subject to the 3.8% income tax under Section 1411 (the "Medicare" tax).

36 See Section 4974.

37 Contributions made by any employer to a qualified retirement plan for an employee usually is not included in the employee's gross income when contributed but only when distributed to the employee (or to the employee's beneficiary if the employee dies before the vehicle has been exhausted).

38 See Section 408A.

39 See Choate, seminar outline, "The 201 Best & Worst Planning Ideas for Your Client's Retirement Benefits," 2014 edition, published electronically as a Special Report by Ataxplan Publications, www.ataxplan.com. But cf. Horwitz and Damicone, "A Decent Proposal," 150 Trusts & Estates 46 (November 2011).

40 See Section 664(c).

That would mean 92.72% of the distribution may be subject to ordinary income tax as high as 39.6%, producing an effective income tax of 36.72%. Hence, the effective net income tax rate of 36.72% combined with the 55.4% effective state and federal estate tax rate brings the total to 92.12%.

If the distribution also is subject to state and local income tax, the combined tax also could be very significant. Distributions from plans are not subject to the 3.8% net investment income tax imposed by Section 1411.

Charitable remainder trusts. A charitable remainder trust (CRT), described in Section 664, provides for annual payments to one or more individuals (or other noncharitable persons) for a specified period and then terminates in favor of charity. A CRT is exempt from income tax (except for unrelated business taxable income).[40] However, distributions are included in the gross income of any beneficiary to the extent the trust holds previously undistributed gross income. Hence, a CRT provides a mechanism only to defer income taxation and just to the extent its gross income exceeds the amount currently distributable or distributed.

One form of CRT (which limits distributions to no more than income determined by state trust accounting rules) may provide greater flexibility in the timing (and therefore the income taxation) of distributions from the trust to a beneficiary. The amount that may be distributed from such a trust, however, is limited by special rules. Moreover, a significant interest in the CRT must be devoted and ultimately pass to charity (at least 10% on a present value basis as of the time of the contribution to the trust) which if deductible for income tax purposes reduces the cost of such charitable interest.[41]

A comparison between using an annuity or a CRT, to defer and ultimately reduce the effective burden of income tax, is difficult to make but it is at least arguable that the greater flexibility of an annuity (as to timing of distributions and the fact that the property need not pass to charity) would seem to favor an annuity over such a trust. However, the CRT may offer at least one benefit that an annuity will not, which is the ability to contribute appreciated property to the vehicle without having the appreciation immediately subjected to income tax. In any event, a charitable remainder trust is not as

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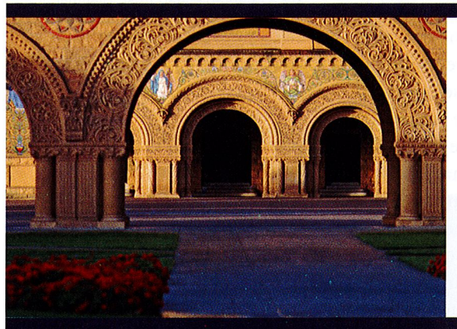

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certain as an annuity may be to provide income tax deferral until the earnings realized in the annuity are recognized for income tax purposes which almost always will be no later than when distributions from it are made. As indicated earlier, a trust, in general, may not hold an income tax deferred annuity. So no comparison between a trust creating a charitable remainder trust or acquiring a tax-deferred annuity can be effectually made.

Charitable lead trusts. Unlike a charitable remainder trust, a charitable lead trust[42] (CLT) makes annual payments to charity for a period of time and then may pass to noncharitable beneficiaries, and it is not exempt from income tax.[43] A CLT may be structured as a grantor trust for income tax purposes[44] which means the tax income of the trust will be attributed directly to the trust's grantor (while living). In such a case, the grantor is entitled to a charitable income tax deduction for the value in the trust, when created, deemed devoted to charity which can be the entire trust's initial value. However, as indicated, the trust's tax income will be included in the grantor's gross income and without any further charitable deduction even to the extent such income is paid to charity. The CLT also can be structured other than as a grantor trust in which case the grantor will not be entitled to an income tax deduction but the trust may be entitled to an income tax deduction as its income is paid to charity.[45] Hence, an appreciated asset could be contributed to a CLT and, to the extent any recognized gain is paid to charity, the trust may be entitled to an income tax deduction.

CLTs usually are not viewed as a method to build wealth for the grantor by avoiding income tax because, under the trust, income or gain is diverted to charity. They can, however, be used to increase wealth passing to descendants (or others), typically not so much by reduction in income tax but by earning more in the trust than the IRS assumes will be earned.[46]

Attempts have been made to structure a CLT as a grantor trust so the grantor is entitled to an income tax deduction for the value of the interest in the trust devoted to charity without significant taxable income being attributed back to the grantor. Arguably, all of these attempts will not produce that result and could create a tax "doomsday." The one potential exception is to fund a CLT with a special form multi-life policy.[47]

Life insurance. It seems surprising that many investors are unaware that the only vehicle that permits true income-tax-free accumulation of wealth, other than a Roth IRA, is life insurance. Subject to complying with certain unique rules, the cash value or investment component of a life insurance policy grows free of income tax. Then, when the death benefit is paid upon the death of the insured, even that portion of the death benefit attributable to the untaxed income is excluded from gross income. Moreover, the untaxed income inside the policy may, in some cases, be borrowed without income tax effect prior to the death of the insured.[48]

The question seems naturally to arise why all investments are not made through a life policy to avoid income tax. Several reasons may be present. The owner must pay for the true risk-of-death component (commonly called the "term," "pure," or "net amount at risk" component) under the policy. Generally, to achieve the income-tax-free build-up of wealth under the policy, a minimum "net amount at risk" must be held in it.[49] That component of the policy may be viewed as a poor investment.[50] The insurer also will charge certain fees or administrative costs and will limit investment choices. In addition, the federal government and all states impose a type of excise tax on insurance premiums, which reduces the amount invested inside the policy.

One way in which costs may be reduced and investment flexibility improved is to acquire a "private placement" policy. Substantially more investment opportunities may be present but, in all events, will be more restrictive than making investments directly. Perhaps, for some, the greatest limitation is the "investor control" rule. It is a rule or "doctrine" that the IRS has developed and has now been upheld, at least to a limited degree, by the Tax Court, that essentially provides that if the income tax owner of the policy may direct (or as a practical matter does

41 It appears that, if authorized, a trust may create a charitable remainder trust. See discussion in Blattmachr and Zeydel, "Split Interest Trusts Created by Entities (and More)," 49 Heckerling Institute on Estate Planning at ¶ 1204.

42 See Section 170(f)(2)(B).

43 It appears that, if authorized, a trust may create a charitable lead trust. Blattmachr and Zeydel, *supra* note 41.

44 See Sections 671 through 679.

45 See, e.g., Blattmachr, "Charitable Trusts and Insurance: Setting the Record Straight," 41 ETPL 3 (June 2014).

46 See e.g., Zeydel, "Estate Planning in a Low Interest Rate Environment," 36 ETPL 17 (July 2009).

47 See Blattmachr, *supra* note 45.

48 See Lipkind and Blattmachr, "Income Tax Aspects of Variable Life Insurance Policies," 122 J. of Tax'n 52 (February 2015).

49 See Section 7702(a).

50 It has been observed that the return on this component is inversely related to when the insured dies: The sooner the insured dies, the greater the return; the later the insured dies, the lower the return. See Blattmachr and Pasquale, "Buying Life Insurance to Fund Estate Taxes," 151 Trusts & Estates 27 (July 2012).

51 See Webber, *supra* 29.

52 See SwissGuard International, "Insurance-Dedicated Fund (IDF)," www.swissannuity.com/php/what_we_do/international_investment_strategies/what_we_do_international_insurance.php (last visited on 2/10/2016).

direct) the investments made within a fund "inside" the policy and may benefit from the income earned, the income earned in the policy will be attributed to the owner as though it had been directly received by the owner.[51]

However, an owner may have significant investment flexibility with a private placement policy. For example, the owner may direct the sale of one investment vehicle held under the policy to another, such as from one hedge fund to another (if each is structured as an "insurance dedicated fund"[52]).

Whether the income-tax-free environment a policy offers will increase wealth depends upon several factors including whether particular investments are offered under the policy and the need to avoid the investor control doctrine. Assuming those and certain other factors do not foreclose the use of a life policy, a comparison still must be made whether the avoidance of tax will more than offset the additional costs incurred by investing through the policy. A basic formula can be used to help make that determination. *The use of the policy to make investments will increase wealth only if the anticipated annual return on the investment is greater than that quotient of the annual cost of the policy (expressed as basis points) divided by the anticipated annual income tax rate (also expressed as basis points) on the return.*

For example, if the anticipated annual cost of the policy is 1% (i.e., 100 basis points) and the anticipated tax rate is 25% (or 25 basis points), the quotient is four (that is, 100 divided by 25). Hence, consideration of acquiring the investment through a policy makes sense only if it is anticipated the return will be more than 4% a year. However, it often is difficult to determine if that will be the case. First, although the costs of the policy usually are stable, they rarely are guaranteed. Second, income tax rates often change. Third, the anticipated annual investment return may not be achieved.

The bottom line, so to speak, is that investing in a private placement (or other life) policy probably should be made only if the owner is confident of having investments available that produce annual yields (and subject to income tax rates) substantially above the quotient described above. That might be viewed as occurring with respect to certain hedge funds, especially for individuals who reside in jurisdictions with high state and local income taxes, such as New York City and California.

Conclusion

Building wealth through investments is challenging. Adopting a sound investment strategy is important. But successful methods of investing have changed as investment choices have changed and as market information has become more accessible. With a more efficient market, certain current investment strategies that search for inefficiencies will be less productive and make markets seem more random. However, machine intelligence is now being used to find patterns in markets providing new opportunities for investment success. Yet, successful investments are reduced by taxes. Because higher returns are more greatly eroded by taxes, planning to reduce taxes must be considered when greatly successful investment returns are anticipated. Although many opportunities may be available to reduce tax, the use of life insurance may be the most efficient in some cases. ■

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