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A TAX PROTECTED ROTH CONVERSION STRATEGY

How to Convert to a Roth IRA Without Digging Into Your Pockets

Now that the fiscal cliff has come and gone without anything falling over, estate planners can advise their clients with much more certainty about our nation's estate and gift tax laws. Besides the maximum rates for estate, gift and generation-skipping transfer taxes increasing from 35% to 40%, all other major laws remain intact. In fact, the other major laws have been granted "permanency", rather than a mere temporary extension from the 2010 tax act. Even though future legislative changes can always occur, this was welcomed with open arms by the estate planning community, since it allows more certain guidance to clients regarding future tax planning. To recap the changes (or lack thereof) to the estate and gift tax laws: the estate and gift tax exclusion amount continues to be $5 Million, adjusted for inflation ($5.25 Million in 2013[1]); the unlimited marital deduction remains intact; portability became permanent law; and the 2013 gift tax annual exclusion has been indexed up to $14,000.

So now that we know that the fiscal cliff has passed without causing much damage, let's get back to estate planning. Many articles have been written comparing the advantages and disadvantages between a Traditional IRA and Roth IRA. Overwhelmingly, the Roth IRA is preferred because of the opportunity for multi-generational income tax deferral. In general, Traditional IRAs must begin a pattern of taxable distributions, typically beginning in the year that the account holder reaches age

[1] As noted above, Congress permanently set the estate and gift tax exemption at $5 Million per person, indexed for inflation. If a client used their full gift tax exclusion in 2012, they now have another $130,000 to give away gift tax free this year, and that number will continue to grow in the future as long as Congress does not set any limits.

70½. These Required Minimum Distributions ("RMDs") are approximately 3.65% at age 70, but increase each year, such that at age 85, they are 6.76%, and at age 93, they exceed 10%[2]. Since Roth IRAs do not have Required Minimum Distributions ("RMDs") during the lifetime of the IRA owner or their spouse[3], the tax deferred growth can inure to the benefit of the next generation. However, individuals who wish to convert an existing Traditional IRA to a Roth IRA must pay taxes at their ordinary income tax rates on the amount converted, thus accelerating the payment of otherwise deferrable income taxes. Smaller accounts may not create a big tax burden, but richer IRA conversions create tax recognition of large amounts and incur a big tax bill.

This article outlines a strategy for the charitably inclined taxpayer that will allow them to convert to a Roth IRA without digging so deeply into their pockets for taxes.

A. Einstein Would Have Preferred a Roth IRA

Before we discuss how the Tax-Free Protected Roth Conversion works, it is important to emphasize exactly why the Roth IRA is so attractive. Albert Einstein once said, "The most powerful force in the universe is compound interest." In other words, a dollar today is worth more than a dollar tomorrow. Why? Because you can invest that dollar today and watch it grow. Understanding this "***time value of money***" principle is often what allows us to create wealth.

To illustrate this idea, suppose you have a Traditional IRA today consisting of $50,000 of growth stocks, which you estimate will grow to three times as much by the time you withdraw it. If your assumptions are correct and you leave your IRA alone, the

[2] Refer to the "Uniform Lifetime Table" for a year by year list.
[3] If a surviving spouse rolls over a Roth IRA from the deceased spouse's Roth IRA, then the surviving spouse does not have RMDs during his or her lifetime.

IRA will have grown to $150,000. Assuming you are in a 35% tax bracket at the time of the withdrawals, after paying $52,500 in taxes, you will have $97,500 of spendable cash.

Now, if instead you made the conversion to a Roth IRA today and paid the $17,500 income tax from the account itself, you will be left with $32,500. If that triples to $97,500, the two outcomes are identical. There appears to be no difference between using a Traditional IRA and a Roth IRA.

However, there is another option. Suppose you convert to a Roth IRA today, but come up with the $17,500 in initial taxes from some other source of cash that would not have qualified for tax-deferred compounding. Assuming the same growth rate, your Roth IRA would have tripled in value to $150,000, a full $52,500 more than the Traditional IRA. Best of all, the entire amount would be income tax-free when you wish to make withdrawals. The $17,500 from the outside account could have grown had it not been used to pay the conversion taxes, but its growth would have been stunted by the fact that you were paying taxes annually on the income it generated all along.

In this case, the "***time value of money***" is definitely on your side. By paying the initial taxes from a source outside the IRA and allowing the full amount of growth in the IRA to be tax-free, you can create significantly more overall wealth than a Traditional IRA. If Albert Einstein were alive today, he would probably be calling *you* a genius.

B. The Tax Protected Roth Conversion

So how can you convert to a Roth IRA without writing a big check to the government? The strategy is centered on marrying several different income, gift and estate planning techniques. The first step is the creation of a charitable trust. Section 170 of the Internal Revenue Code provides an income tax deduction for charitable donations.

For those individuals who are regular donors to charity, an opportunity exists to convert from a Traditional to a Roth IRA without increasing your conversion year's tax bill significantly. This is done by creating a large upfront charitable income tax deduction to shelter the taxable income created by the conversion. Although there are several options to choose from, the best charitable trust in today's low interest rate environment is the Charitable Lead Annuity Trust ("CLAT"), which is treated as a Grantor trust for income tax purposes.

1. A Two-For-One Tax Benefit Special Upon the Creation of a CLAT

The central idea of a Charitable Lead Annuity Trust (CLAT) is that the trust pays a pre-determined dollar amount to a qualified charity (the charitable lead) for a certain term of years, with the amount remaining in the trust after the term ends being distributed to the Grantor's designated personal beneficiaries (the "remainderman"). If the investments perform reasonably well over that term, the growth of the trust may outperform the payments made to the charities, thus leaving at the term's ending a sizable portion or even more than the original trust deposit available to the Grantor's designated personal beneficiaries without further gift taxes. For our purposes, this Grantor CLAT creates two (2) separate charitable tax benefits for the donor: an income tax deduction ***and*** a gift tax deduction both equal to the present value of the stream of annual payments that will be paid to charity during the term of the CLAT. Under the "Grantor trust income tax rules", this deduction will apply to the Grantor's taxable income.

To illustrate, suppose a Grantor creates and funds a Grantor CLAT with cash or other assets (preferably not from the traditional IRA assets). Under the specific details of the trust, annual distributions are made from the CLAT to a charity for a period of time

chosen by the donor at the inception of the trust. The distributions can be made to a qualified charity, or to a Donor Advised Fund ("DAF"). The donor will receive an immediate tax deduction for the present value of this stream of future charitable gifts if the trust is treated as a Grantor trust for income tax purposes.

At the end of the trust term (for example 15 to 20 years), the remainder interest passes to the Grantor's designated personal beneficiaries with no further gift or estate taxes. This scenario provides two charitable tax benefits for the donor: 1) an income tax deduction, ***and*** 2) a gift tax deduction. As noted above, the value of the deduction is the present value of the future charitable gifts the CLAT will make. The income tax deduction reduces the Donor's taxable income (including that generated by the Roth conversion). The gift tax deduction reduces the taxable gift that can eventually benefit personal beneficiaries at the end of the CLAT.

A contribution to a CLAT is considered "for the use of" a charity, and thus subject to the percentage limitations on charitable deductions that apply to private foundations. Additionally, the amount of the charitable deduction will vary depending on the type of property transferred to the CLAT. For example, the charitable deduction for a contribution of cash or qualified appreciated stock in a publicly traded company to a CLAT is limited to 30% of the grantor's adjusted gross income in the year of funding. Any excess deduction can be carried over and used over the following 5 years.

Planning Point

Rather than having the CLAT itself make distributions directly to the chosen charities, some clients choose to make the CLAT distributions to a Donor Advised Fund ("DAF"). The result might be that the DAF will build assets that might continue beyond

the term of the CLAT. This situation may provide an opportunity for the Grantors, as well as other family members, to participate in charitable giving from the DAF over a long period of time.

Income Tax Benefit

Currently, due to the existing low interest rate environment, this CLAT contribution can create an immediate income tax deduction of 75% to 90% or even more of the value of the assets transferred to fund the CLAT. The deduction will be determined based on the term and level of distribution from the CLAT as well as the Applicable Federal Rate ("AFR") at the time the trust is funded.

Key Planning Point

This charitable income tax deduction can be used to offset the taxable income that will be created by the conversion from a Traditional to a Roth IRA.

Gift Tax Benefit

Second, under IRC Section 2522, for purposes of gift taxes, the value of the gift of the remainder interest in the inter-vivos CLAT will be reduced by an amount equal to the present value of the charitable lead interest. As a result, the value of the taxable gift will most likely be reduced to less than 10% to 25% of the amount transferred to the CLAT.[4] Any appreciation of trust assets in excess of the §7520 rate in effect at the time of the gift will pass to the remainderman free of gift tax.

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[4] It is even possible to structure a CLAT so that it is "zeroed out." In a zeroed out CLAT, the present value of the charitable lead interest is equal to the fair market value of the property contributed to the CLAT. This leaves the present value of the non-charitable remainder interest equal to zero. As a result, the transfer to the CLAT will not be subject to gift or estate tax.

In addition, under the rules governing taxation of Grantor trusts, the Grantor will pay the income taxes each year on the CLAT's taxable income. As a result, the remaining interest ultimately paid to the personal beneficiaries will be greater than if the CLAT paid the income taxes on income and gain each year. These payments have the effect of an indirect transfer to the next generation, but without any gift tax implication. This further reduces the Grantor's taxable estate without a taxable gift.

Planning Point

In order to take advantage of the Tax Protected Roth Conversion ("TPRC"), clients whose Wills currently provide for testamentary charitable gifts, might want to consider accelerating those gifts to make them during their lifetimes. Testamentary charitable gifts only provide an ***estate*** *transfer tax savings. However, lifetime charitable gifts provide both* ***gift*** *transfer tax savings as well as* ***income*** *tax deductions. Those lifetime income tax deductions will provide the opportunity to implement a Tax Protected Roth Conversion. The TPRC will save further taxes on IRA distributions during the lifetime of the Grantor/IRA account holder and their children when they inherit the Roth IRA distributions.*

2. Increasing Payment Annuity CLATs

There are several creative ways to structure CLAT's in order to receive the most benefits. Traditionally, CLATs simply had payments to charity in the same amount every year. However in 2007, the Internal Revenue Service issued sample forms for inter-vivos CLATs and testamentary CLATs, which provided that the annuity paid to the charity may increase every year, provided that the payment to charity is ascertainable at the time the

CLAT is funded.[5] Thus, a CLAT can be structured so that the amount passing to charity in the first year of the CLAT is relatively small and gradually increases over the term of the CLAT. By making only small distributions to charity in the initial years of the CLAT, strategically the trust principal has additional time to grow before larger distributions must be paid out to the charity in later years. This is also very helpful if the CLAT experiences a market downturn in value in the early years.[6]

Key Planning Point

With §7520 rates near historic lows, now may be an opportune time to create a CLAT.

3. Impact of the Pease Amendment on Charitable Giving

The fiscal cliff did reinstate a limitation to itemized deductions, including charitable giving. The Pease Amendment is named after Ohio Congressman Donald Pease who helped create it in 1990. The Pease phase-out only affects taxpayers with AGIs above certain amounts: Married filing jointly: $300,000; Head of household: $275,000; Single: $250,000; and Married filing separately: $150,000. Certain itemized deductions (including home mortgage interest, state and local taxes, and charitable contributions) are reduced by the *lesser* of 3% of the amount by which AGI exceeds the threshold amounts listed above; or 80% of unprotected itemized deductions.

Under the "Tax Protected Roth Conversion", the conversion itself increases the effect of the "Pease Amendment" itemized deduction phase-out. For example, assume a

[5] Rev. Proc. 2007-45 and Rev. Proc. 2007-46

[6] Another form of increasing CLAT is known as a Shark-Fin CLAT. A Shark-Fin CLAT is a more dramatic form of the Back Ended CLAT. It provides for very small distributions to charity in all but the final year, in which a large distribution is paid.

married tax payer filing jointly whose income before the Roth conversion was $500,000. If they created a CLAT which generated a $500,000 income tax deduction and at the same time converted $500,000 to Roth, their gross income would increase to $1,000,000. As a result of the Pease Amendment, the itemized deductions for the CLAT would be reduced by $15,000 ($500,000 CLAT deduction amount x 3%). Therefore the $500,000 CLAT deduction would be reduced to $485,000. As this example illustrates, this reduction is not very large and is tolerable, even for very high tax payers.[7]

Notably, taxpayers who pay the Alternative Minimum Tax ("AMT") are not impacted by the Pease amendment. They receive the full benefit of their charitable contribution deductions at the AMT rates of 28% or 26%.

Planning Point

The Pease Amendment only effects income tax, and does not reduce the gift tax deduction associated with the Tax Protected Roth Conversion.

4. Tax Treatment at the State Level

There are 48 states that currently do not have a gift tax.[8] With governments searching for revenue, there is no telling whether some states will enact a gift tax in the future. So now may be an opportunity to make gifts, whether it is by setting up a CLAT or making gifts for insurance premiums, without being subject to state gift taxes. Also, some states may limit a deduction for the full amount of charitable gifts. Currently, taxpayers with New York AGI more than $1 Million and less than $10 Million are

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[7] Of course in any given year, the overall charitable deduction is limited to 30% of Adjusted Gross Income with the excess carried over for up to 5 additional years.

[8] The exceptions are Connecticut and Minnesota. Minnesota's addition of a gift tax effective July, 1st 2013 may portend changes to come to other states.

limited to a 50% deduction, and taxpayers with New York AGI over $10 Million are limited to a 25% deduction.

C. Completing the Strategy: Life Insurance to Provide Liquidity When Needed

The final piece of the Tax Protected Roth Conversion strategy is the purchase of life insurance. Upon the death of the Grantor, the full value of the Roth IRA is included in the estate for estate tax calculation purposes. After the Roth IRA conversion, the Roth IRA has no Required Minimum Distributions and therefore no income tax during lifetime. As a result, when you compare the Roth IRA to a Traditional IRA, even with identical earnings over the same time horizon, the Roth IRA will be significantly larger. This will increase the size of the estate, which can lead to greater Federal, and if applicable, State Estate Tax. Of course, it is a good thing having more assets even though there are more taxes. In order to maximize the benefits of the Roth income tax deferral, any estate taxes attributable to the Roth account should be paid from non-Roth assets. It is best to look for a liquid asset that can be both income tax free, ***and*** outside the taxable estate. Life insurance owned by an Irrevocable Family Trust can provide the needed cash to the beneficiaries for estate taxes when needed, at the death of the account holder or the surviving spouse. Also, because of the special exclusion afforded to life insurance, there will be no income tax on its death benefit.

This Trust can purchase life insurance on either the life of the Grantor (or Second to Die on the Grantor and spouse), and can also serve as the remainderman for the CLAT assets at the end of the CLAT term.[9] Since life insurance death benefits are income tax free, these assets may eventually be made available to the beneficiaries who can choose

[9] The Grantor can consider using a part of the additional $130,000 in the gift tax exclusion for 2013 for payment of life insurance premiums.

to use them to help pay the estate taxes on the included Roth IRA when the Grantor (or spouse) have both died. This can greatly enhance the value that the Roth family beneficiaries will receive if they do not have to use the Roth or other estate assets to meet liquidity needs.[10]

Alternatively, the CLAT itself can purchase the life insurance. During the term of the CLAT, the CLAT would be the named beneficiary. At the end of the CLAT, the policy itself (or its death benefit, if a claim occurred during the term of the CLAT), would pour over into the Irrevocable Family Trust, along with the remaining assets in the CLAT.[11]

D. Example of the Tax Protected Roth Conversion Strategy

To see how the entire strategy works in unison, consider the following illustrated example:

1. A Grantor contributes $500,000 in cash or assets to a CLAT, which is taxed as a "Grantor Trust" for income tax purposes. The Grantor receives an income and gift tax deduction equal to the present value of the annual payments to be made to the charity, which equals $409,586 (82%). At the end of the 15 year

[10] If available, the authors recommend a client consider a Guaranteed Universal Life ("GUL") policy. The GUL policy provides the greatest guaranteed death benefit for a given fixed outlay of premium, generating the highest internal rate of return compared to other life insurance products currently available.

[11]The Authors described two alternative approaches above as to which Trust should purchase the Life Insurance: either (1) inside the CLAT, or (2) in an Irrevocable Family Trust. Due to IRC Section 170(f), some commentators' state that Life Insurance purchased inside a CLAT could be problematic. Other commentators take the position that as long as the CLAT is the beneficiary of the Life Insurance policy during the time period when the CLAT owns the policy, that this should not be an issue. To be on the conservative side, clients generally opt for policy ownership from inception by the Irrevocable Family Trust.

CLAT term, any remaining assets will pass to an irrevocable trust for the benefit of the family (Irrevocable Family Trust).

2. The Grantor then converts $409,586 of Traditional IRA to a Roth IRA. Subject to the normal charitable and itemized deductions, the charitable deduction created by the CLAT will largely shelter the taxable income created by the Roth conversion. As a result, the Grantor has little or no additional income tax to the government for the Roth conversion amount.
3. The CLAT (or the Irrevocable Family Trust) purchases life insurance on the life of the Grantor for $1,000,000.
4. Over the following 15 years, the CLAT makes annual contributions to a Donor Advised Fund, a Foundation or other qualified charity, totaling $450,000.[12]
5. At the end of the 15 years, the CLAT terminates and distributes its remaining assets to the Irrevocable Family Trust, which is named as the remainder beneficiary.

Result: Assuming the Grantor dies at life expectancy, and assuming a return of 6% on both the Roth assets and the CLAT assets over the beneficiaries' life expectancies, they will inherit a Roth IRA valued at $1,757,890 (includible in the Grantor's taxable estate for Federal and if applicable, State Estate tax purposes). The life insurance proceeds (on the lives of the IRA owner and/or Spouse) can be made available to the

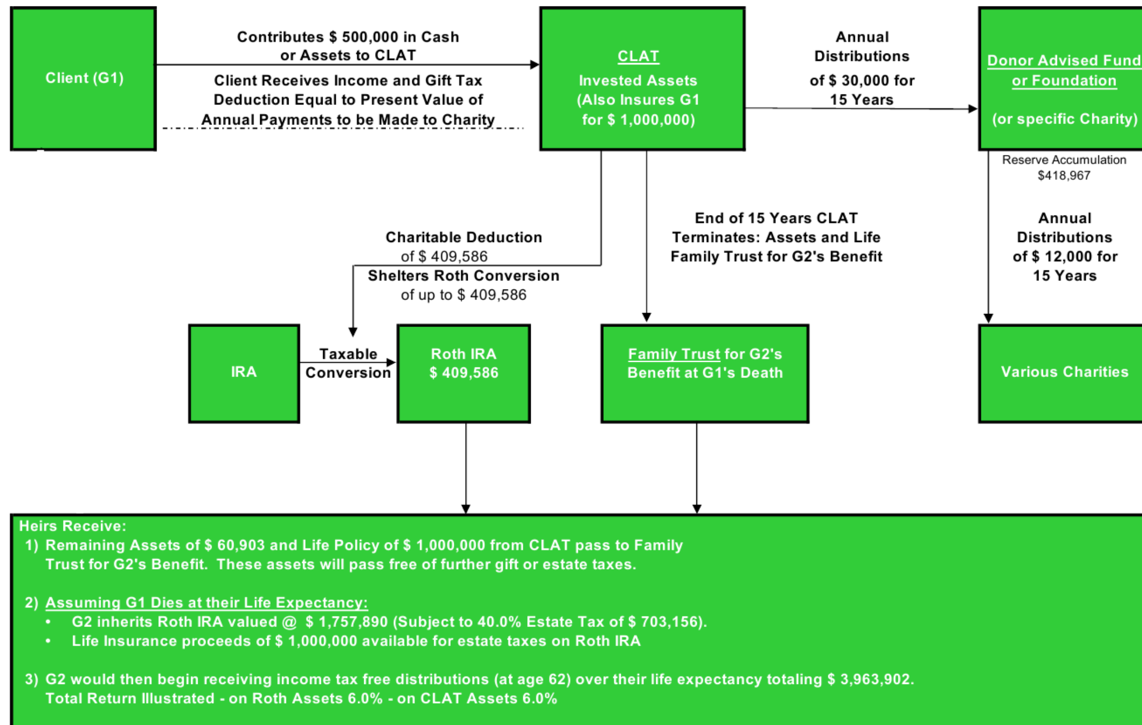
[12] A question may arise as to whether a completed gift occurred at the time of the initial transfer if the Grantor holds a fiduciary position with the charitable beneficiary. The IRS may take the position that the Grantor's control of a private foundation means that the gift to the Charitable Lead Trust (CLT) is incomplete. Many tax advisors suggest that the Grantor should not make grant recommendations or be involved in the foundation's grant-making decisions in respect to assets distributed from the CLT to the foundation. Other family members may participate in such grant-making decisions.

beneficiaries to pay any State or Federal estate taxes associated with the inherited Roth IRA or any other assets, as well as other estate planning needs. Some advisors also point out that any insurance proceeds not needed for estate taxes also serves as a form of wealth replacement for the gifts to charity.

The beneficiaries would then begin receiving income tax free distributions from the Roth IRA. In this example, if the Roth account holder dies at their life expectancy, then tax free Required Minimum Distributions would be based on the beneficiary's life expectancy. These payments to the beneficiaries, from their then attained age 62 through their life expectancy would total $3,963,902.[13,14]

[13] This strategy does not prevent a client from drawing from the Roth IRA on an ad hoc or regularly planned manner during their lifetime. This figure represents annual Required Minimum Distribution payments based on the Uniform Lifetime Table beginning at age 62. Age 62 is the attained age of the beneficiary at the time of the older generation accountholder's life expectancy.

[14] The example illustrated here assumes a 6% level return on the investments of both the assets in the 15 year CLAT, as well as from the Roth IRA over the combined life expectancies of the IRA account holder and their beneficiary. As noted in the example, a 6% return would yield total tax free distributions to the beneficiary over their lifetime of $3,963,902. Alternatively, at 5% those distributions would total $2,703,866 and at 7% would be $5,818,630.



An Alternative Approach: A CLAT with Increasing Charitable Distributions

The example above is based on an assumption that the annual distribution from the CLAT to a charity or a Donor Advised Fund will be for a level dollar amount each year. Alternatively, as described earlier (in Section B(2) Increasing Payment Annuity CLATs, it is possible to structure the annual distributions as increasing each year under a fixed formula contained in the terms of the CLAT document.

To illustrate the idea of this increasing annuity payment CLAT, assume the following:

- A Grantor creates a 15 year CLAT funded with $500,000,
- The §7520 rate is 1.4%,
- A 6% growth rate on the CLAT's assets,
- An initial annuity of $7,500 increasing by 20% each year.

By structuring the CLAT as a Grantor trust, and by increasing the annuity payments by 20% each year, the charitable deduction would be $463,988 (93%). This would allow for a significantly higher Roth conversion with the resulting additional income tax free Roth distributions to the account holder's children.

E. Let's Review the Steps to the Process of Creating a *Tax Protected Roth Conversion*:

1. The client creates a Grantor Charitable Lead Annuity Trust and funds that trust with cash or other assets.
2. The client receives a significant income tax deduction (approximately 80% to 95% of the contribution to the Grantor CLAT) and in addition receives a gift tax deduction for the remainder interest (approximately 80% to 95% of the CLAT funding), which will ultimately pass to the children.
3. The client converts an amount of either IRA or qualified plan assets equal to the CLAT's generated income tax deductions into a Roth account.
4. The client also facilitates a trust which in turn purchases life insurance on their life. That trust can provide a source of liquid assets to the children which can help with Federal or State Estate taxes associated with the Roth account.
5. At the end of the CLAT period (typically 15 to 20 years), the balance of the assets left in the CLAT can pass to the trust that was created to purchase the insurance for the children's benefit.
6. There will be no Required Minimum Distributions from the Roth during the lifetime of the client. Therefore, the entire Roth account can grow without withdrawals for the benefit of the Grantor's beneficiaries.

7. a) At the death of the client, the life insurance policy will mature and can be available to lend or distribute cash to the children which can help them deal with estate taxes.

   b) At the death of the client, the distributions from the Roth IRA will begin to the children over their life expectancies. At this point, it is likely that the children will be middle age or even at or in their own retirement years.

Key Planning Point

Now consider this: if your client would likely be making these charitable gifts during their lifetime or on a testamentary basis, all the benefits of this Roth conversion strategy can be available to your client by simply restructuring their charitable gifts in this manner.

F. Conclusion

So what has been accomplished? The strategy we have outlined will allow a charitably inclined client to convert to a Roth IRA without increasing their income taxes substantially. Further, as shown in the example herein, the income tax free distributions from the Roth IRA to the beneficiaries could grow to between 8 to 12 times the amount actually converted. This compound growth is what Einstein referred to as the most powerful force in the universe. He would have loved the income tax free accumulation and distribution environment of a Roth IRA.