Critical Year End Planning for the Mass Affluent

Income of $100,000 to $500,000

Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished)

2023 Planning
Special Focus

- Harvesting Losses
- Roth Conversions
- Crypto Currency
- Estate Administration and Basis
- IRAs After Death

Year-end Planning

Annual General Checklist

- Bracket Management
  - Bonuses
  - Recognition events
  - Time business expenses – AMT awareness
- Itemized Deduction Timing
  - Medical expenses
  - Property tax
  - Charitable contributions
  - Casualty & theft losses
- Gain Harvesting
  - Current < Future rate ?
  - Consider forced recognition events (e.g. warrants)
  - Consider waiting for § 1014(a) basis step-up
- Loss Harvesting
  - Offset gains
  - $3,000 ordinary income offset
  - Cryptocurrency exemption to the wash-sale rule
  - Avoid trapped losses at death and trust termination

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Year-end Planning

Annual General Checklist

- ❑ Retirement Planning
  - ❑ Fund IRAs
  - ❑ Fund 401ks
  - ❑ Fund pension plans
  - ❑ Optimize Traditional/Roth mix
  - ❑ Consider Roth conversions
  - ❑ Review RMDs
  - ❑ Review NUA
- ❑ Education Planning
  - ❑ Time tuition payments
  - ❑ Fund 529 plans
  - ❑ Fund Coverdell accounts
- ❑ Executive Planning
  - ❑ Review NQDC
  - ❑ Review NQSOs / ISOs
  - ❑ Review concentrated positions
- ❑ Charitable Planning
  - ❑ Consider QCD
  - ❑ Consider appreciated assets
  - ❑ Consider DAF
- ❑ Estate Tax Planning
  - ❑ Make annual exclusion gifts
  - ❑ Make medical gifts
  - ❑ Make tuition gifts
  - ❑ Protect non-exempt trusts

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Year-end Planning

Annual General Checklist

- ❑ Estimated Taxes
  - ❑ Review payments & estimated taxable income
  - ❑ Extra payment to reduce penalty
  - ❑ Additional W-2 withholding to eliminate penalty
  - ❑ AMT review
- ❑ Medical Expense Planning
  - ❑ Review Medicare premiums
  - ❑ Review HSA contributions
  - ❑ Review FSA balance
- ❑ Significant Financial Events Next Year
  - ❑ Recognition events
  - ❑ New investments
  - ❑ Re-allocation plans
  - ❑ Vesting
- ❑ Major Life Events Next Year
  - ❑ Family changes
  - ❑ Job changes
  - ❑ Moving

Legislative Update

Tax Provisions of Interest Which Expired in 2022

- **Full Deduction for Business Meals**
  - Coronavirus-related relief
  - 100% deduction schedule to sunset 12/31/22
  - Reverts to only 50% of the expenses deductible

Tax Provisions of Interest Expiring

- **Bonus Depreciation**
  - The TCJA provided for 100% bonus depreciation (i.e. 100% deduction for property that would otherwise be capitalized & depreciated)
  - It is scheduled to phased out in 20% intervals from 2023-2026

2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027	0%

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Inflation Reduction Act Overview

- **Spending:** The most significant provisions are hiring 87,000 new IRS agents and changes to many energy tax credits

Inflation Reduction Act Overview

- **Energy Provisions**
  - Most incentives are for industry, however there are many that your clients may find valuable.
  - **For Homeowners:** There are improvements to the incentives for homeowners to improve energy efficiency and generate clean energy.
  - **For Electric Vehicles:** The per manufacturer limit is removed, but adds a MSRP limit, an AGI limit, and domestic content requirements. Importantly, the credit is made available at the point of sale and a $4,000 credit for used vehicles is added. There is are also changes to the incentives for charging equipment.
  - **For Business Owners:** The credit for clean energy producing property is significantly improved by extending it through 2032, expanding eligible technologies, and adding bonus credits for certain situations. The legislation also includes a credit for commercial clean vehicles; heavy vehicles are eligible for up to a $40,000 credit. Importantly, the Legislation also includes special provisions to allow taxpayers to elect to receive direct payment in lieu of claiming certain credits and allows the transfer of certain credits to other taxpayers.

The EARN Act Overview

“SECURE 2.0”

- Enacted in 2022 and many changes will become effective over the next several years.
- Many small changes of interest to plan administrators.
- Likely changes of interest to a private wealth advisor include:
  - Saver’s credit expansion
  - Emergency expense, hardship, disaster and terminal illness withdraws
  - Catch-up increase and indexing
  - Rollover sample letters
  - Retirement plan lost & found
  - One-time QCD to CRT
  - Changes to allow a surviving spouse to be treated as the employee
  - Expansion of long-term care contracts and
  - SIMPLE & SEP Roth contributions
  - Matching & non-elective contributions treated as Roth Contributions
  - Plan deferrals limited to contributions limits (no mega backdoor Roth)

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Select Expiring TJCA Changes

The 12/31/25 Cliff – Back to 2017 Law

- Individual tax brackets
- Child tax credit
- AMT
- Standard deduction
- Personal exemptions
- Home mortgage interest – acquisition and equity loans
- Charity cash percent limitation
- Misc. itemized deductions, including casualty losses
- PEASE limitation
- Moving expenses
- Student loan & home mortgage discharge
- Certain ABLE account provisions
- IRC § 199A
- Estate & gift tax exemption

Select Expiring TJCA Changes

The 12/31/26 Cliff – Back to 2017 Law

- 461(l) excess business losses
- Bonus depreciation
- SALT deduction limit
- Opportunity zone rollovers

Core Year-End Planning

Tax Rates

*Income Tax Rates **2023***

TOP OF EACH BRACKET

	S	MFJ/QW	MFS	HOH	T&E
10%	$ 11,000	$ 22,000	$ 11,000	$ 15,700	$ 2,900
12%	$ 44,725	$ 89,450	$ 44,725	$ 59,850	-
22%	$ 95,375	$ 190,750	$ 95,375	$ 95,350	-
24%	$ 182,100	$ 364,200	$ 182,100	$ 182,100	$ 10,550
32%	$ 231,250	$ 462,500	$ 231,250	$ 231,250	-
35%	$ 578,125	$ 693,750	$ 346,875	$ 578,100	$ 14,450
37%					

TOP OF EACH CAPITAL GAINS BRACKET

	S	MFJ/QW	MFS	HOH	T&E
0%	$ 44,625	$ 89,250	$ 44,625	$ 59,750	$ 3,000
15%	$ 492,300	$ 553,850	$ 276,900	$ 523,050	$ 14,650
20%					

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Tax Reform

Itemized Deductions

THE <u>OLD RULE</u> WAS TO

<u>ACCELERATE</u> DEDUCTIONS

THE <u>NEW RULE</u> IS TO

<u>TIME</u> DEDUCTIONS

Bracket Management

Itemized Deductions

- Art and Alice are married taxpayers filing a joint return.
- They typically give about $15,000 to charity annually at the end of the year
- The SALT deduction, capped at $10,000, is the only other itemized deduction they can claim

Bracket Management

Itemized Deductions

- If they make their annual donation as usual, they will have $25,000 of itemized deductions; claiming the standard deduction of $25,900 provides a better result

- However, if they lump together their 2022 and 2023 contributions in 2022, their taxable income will be reduced by an additional $14,100 (15+15+10-25.9) in 2022 and their total deductions will be relatively unchanged in 2023 assuming no change in the law.

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Bracket Management

Itemized Deductions

Important

- The AGI limitation for itemized charitable deduction was removed for 2020 and 2021 (i.e. the charitable deduction was limited to 100% of AGI).
- For 2022-2025 it is 60% pursuant to the TCJA.
- In 2026 it reverts to 50%.

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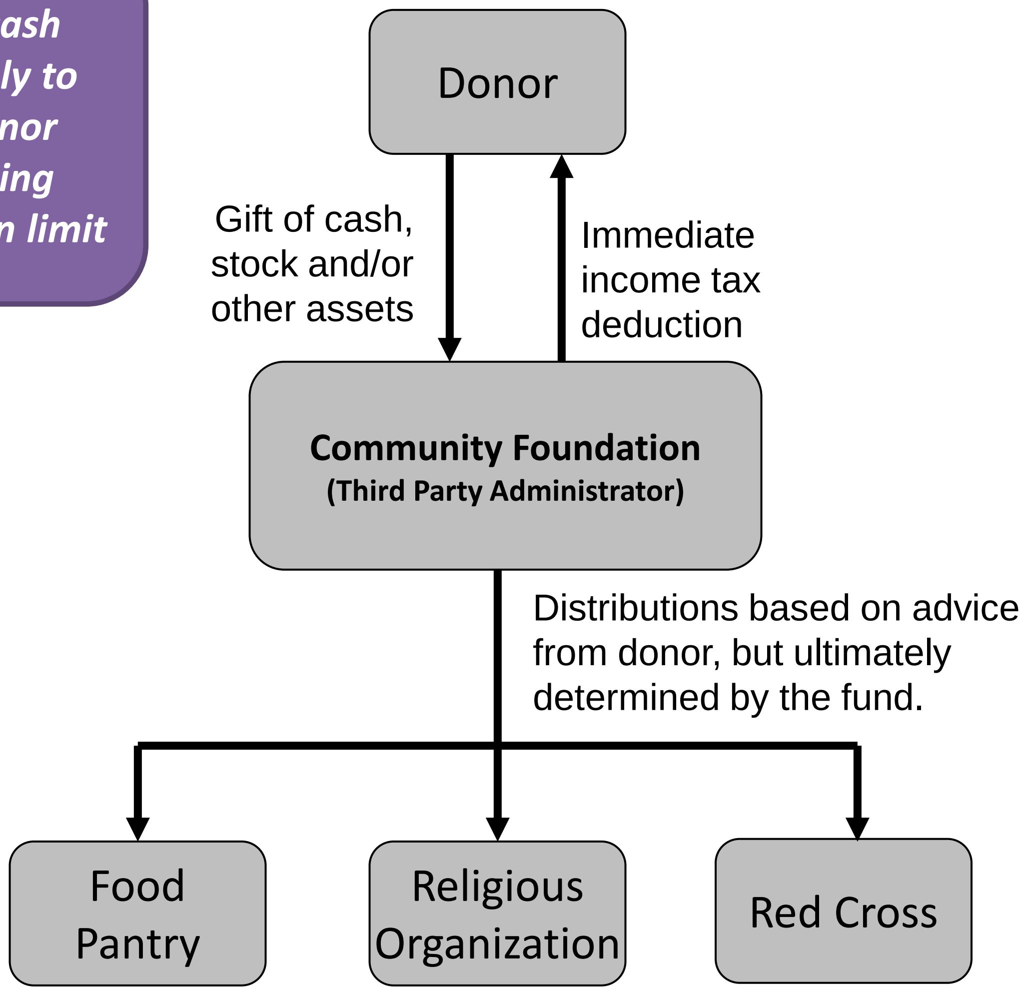
Donor Advised Fund

Overview

The elimination of the percentage limitation for 2020-2021 cash contributions does not apply to contributions made to Donor Advised Funds or Supporting Organizations. The deduction limit is 60% of AGI.



Bracket Management

Itemized Deductions

- ***However – recall the new rule is to time deductions***
- Art and Alice should not merely base their decision on current law.
- For example: If the SALT deduction cap is increased or eliminated they may be better to wait. An increase in their marginal tax rate or a new surtax or phaseout threshold to manage might further increase argument to delay the deduction.

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Gain & Loss Harvesting

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Bracket Management

Harvest Capital Gains

- Strategy:
  - Taxpayer expects to be in a higher tax bracket in the future
  - Sells assets in the current year, pays tax a lower tax rate and steps up basis
  - Repurchases the same or similar assets
- Effect: Shifts recognition of capital gain from a higher future rate to a current lower rate

Bracket Management

Capital Gain Harvesting – Tradeoffs

- On the surface, it appears that taxpayers should always harvest gains
- However, harvesting gains introduces a tradeoff between lower tax rates versus the loss of tax deferral
  - Tax is paid at a lower rate, but it is paid sooner
  - Need to determine a crossover point at which selling sooner makes more sense; A way to conceptualize this would be to use a return on investment (ROI) approach

Bracket Management

Harvest Capital Losses

- Harvesting Capital Losses: Selling assets at a loss to offset capital gains
- Reduces or eliminate tax on current capital gain
- On the surface, loss harvesting produces an economic benefit equal to the tax saved, however it generally only provides a timing benefit.
  - Assets purchased with the proceeds have a lower basis than the assets sold
  - Therefore, more capital gains tax is owed in the future
  - However, deferral remains valuable

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Bracket Management

Efficiency of Harvesting Capital Losses

- Capital losses are more tax effective if they can be used to offset income taxed at higher rates

	Short-Term Gain	Long-Term Gain
Short-Term Loss	NEUTRAL	INEFFECTIVE
Long-Term Loss	EFFECTIVE	NEUTRAL

- *Remember:* Capture the up to $3,000 capital loss which can offset ordinary income!
- *Warning:* Remember the wash sale rule prevents taxpayers from repurchasing a substantially similar security within 30 days of selling at a loss

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College Planning

College Planning

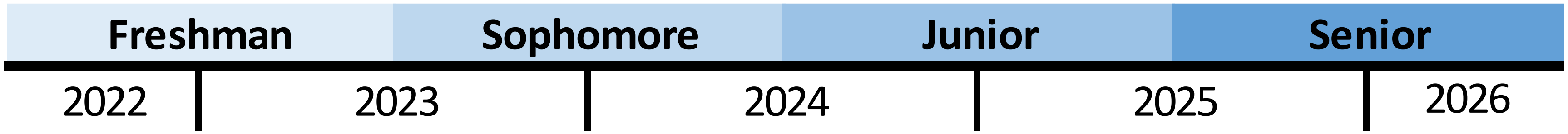
Encourage Clients Fund Saving Plans

- Education Savings Accounts (ESAs) & Qualified Tuition Programs (QTPs/529s)
- Both provide annual tax-free growth & tax-free withdrawals for "qualified education expenses"
- QTPs offer a variety of annual savings incentives which vary by state: deductions, credits & grants
- ESAs can be used for primary & secondary in addition to higher education expenses
- The TCJA expanded QTP "qualified education expenses" to include primary & secondary higher education expenses

College Planning

Carefully Claim the AOTC

- American Opportunity Tax Credit (AOTC) can only be claimed for the first four academic years of a college student and can only be claimed in four tax years.
- This dual limitation can make choosing when to claim the credit difficult because tax years and academic years do not align:



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College Planning

Claiming College-Aged Dependents

- Despite the suspension of dependency exemptions by the TCJA, dependency remains an issue
- Education credits can be claimed by parents who have a student dependent:
  - Students who receive ½ of their support from their parents are dependents
  - Students 24 and over must also not earn more than $4,700 in 2023 to be dependents
- However, parents do not have to claim the child as a dependent – which is beneficial for parents phased out of education credits

Retirement Income Tax Planning

Bracket Management

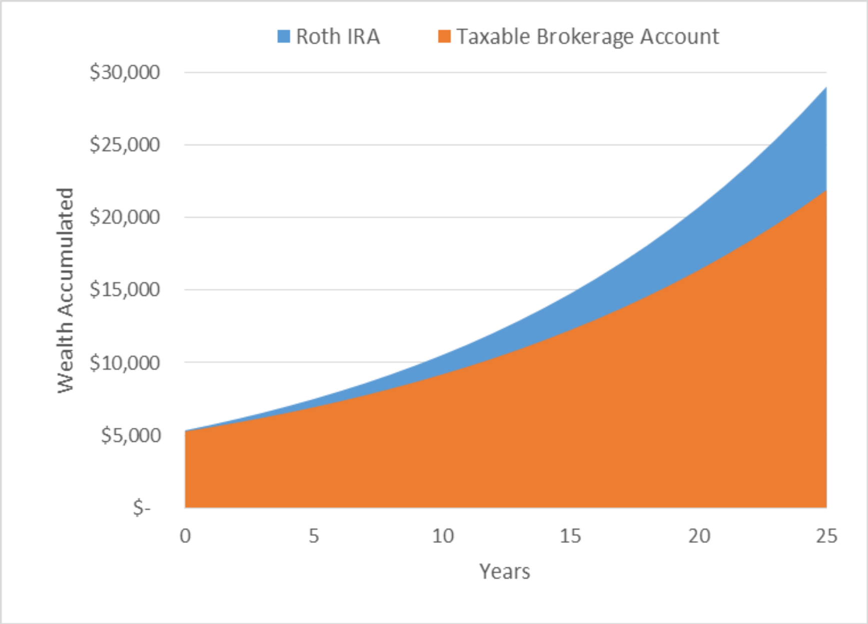
Encourage Retirement Plan Funding

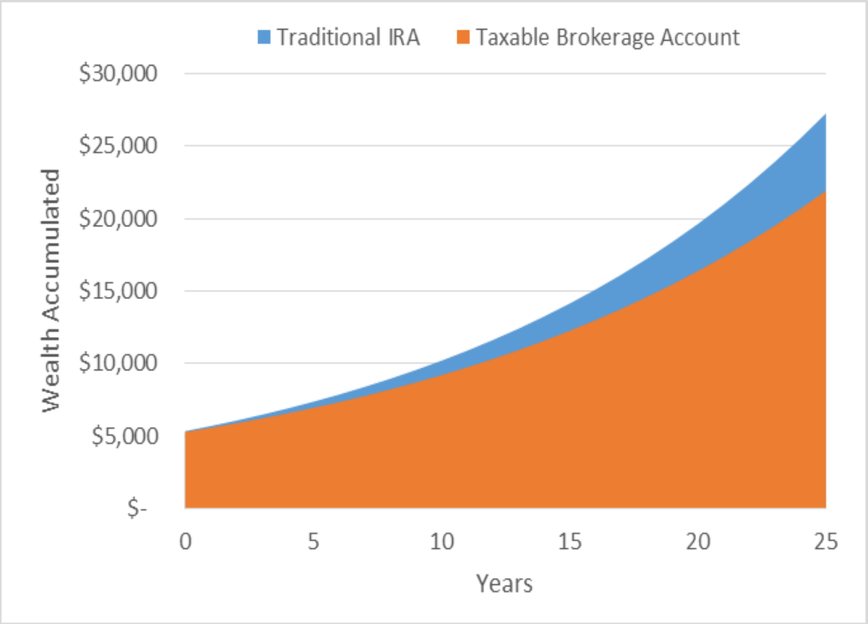
- The 401k and IRA are excellent statutory tax-shelters.
- Remember IRA contributions can be made up to April 15 for the previous tax year
- Deductible contributions can be deceptively valuable by <u>reducing the impact of certain phase-outs.</u>
- Most importantly, the lack of annual "tax-drag" is valuable and therefore an investment in a qualified account will always outperform a taxable investment

Bracket Management

Encourage Retirement Plan Funding

Compare the after-tax value of $5,000 growing in a Traditional or Roth IRA/401k compared to a taxable brokerage account over a significant period of time:





Assumptions: 5% growth rate, 2% yield, 5% annual account turnover, 25% ordinary income tax rate, and a 15% capital gains tax rate.

Defined Contribution Plan 2023 Limits

DEFINED CONTRIBUTION PLAN LIMITS	
IRA / ROTH IRA CONTRIBUTION LIMIT	$ 6,500
IRA / ROTH IRA "CATCH UP"	$ 1,000
401k ELECTIVE DEFERRAL	$ 22,500
401k ELECTIVE DEFERRAL "CATCH UP"	$ 7,500
SIMPLE IRA CONTRIBUTION LIMIT	$ 15,500
SIMPLE IRA "CATCH UP"	$ 3,500
SEP IRA EMPLOYEE PERCENTAGE MATCH LIMIT	25%
SEP IRA SELF-EMPLOYED PERCENTAGE MATCH LIMIT	20%
OVERALL LIMIT ON CONTRIBUTIONS TO DCPs	$ 66,000

Defined Benefit Plan

Contribution Examples

Current Age	DC/401k Contribution	Cash Balance Allocation	Total
35	54,000	70,000	124,000
40	54,000	90,000	144,000
45	54,000	115,000	169,000
50	60,000	145,000	205,000
55	60,000	190,000	250,000
60	60,000	245,000	305,000

Please note these are prior-year figures.

A Special Thanks to Shore-Tompkins for Providing this Slide.

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"Asset Location"

37%
35%
32%
24%
22%
12%
10%
0%

Tax-Free
- Roth IRAs
- Life Insurance
- Tax-Exempt Interest Income

Tax-Deferred
- IRAs, 401(k)s, 403(b)s
- Non-qualified Deferred Annuities

Taxable
- Interest Income
- Capital Gains
- Qualified Dividends

"Asset Location"

Interest Income

- Money market
- Corporate bonds
- US Treasury bonds

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

Dividend Income

- Equity Securities

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

Capital Gain Income

- Equity Securities

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

Tax Exempt Interest

- Bonds issued by State and local Governmental entities

Attributes
- Federal tax exempt
- State tax exempt

Pension and IRA Income

- Pension plans
- Profit sharing plans
- Annuities

Attributes
- Growth during lifetime
- RMD for IRA and qualified plans
- No step-up

Real Estate and Oil & Gas

Real Estate
- Depreciation tax shield
- 1031 exchanges
- Deferral on growth until sale
- 199A Deduction

Oil & Gas
- Large up front IDC deductions
- Depletion allowances
- 199A Deduction

Roth IRA and Insurance

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

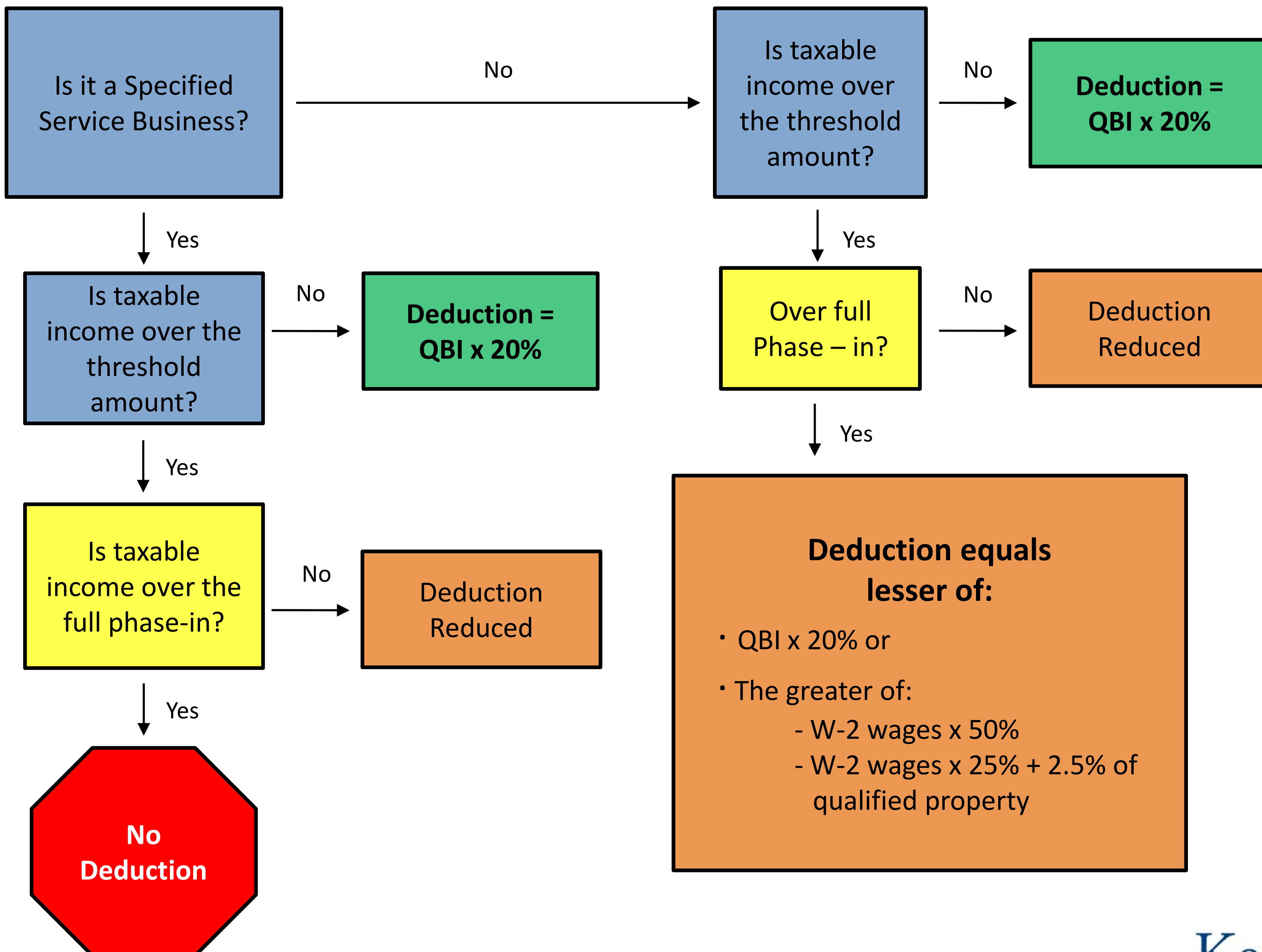
Life Insurance
- Tax-deferred growth
- Tax-exempt payout at death

Qualified Account Basics

A Quick Refresher

	Traditional IRA	Roth IRA	Non-Deductible IRA
Tax Deduction for Contribution	✓		
Tax-free Distributions		✓	Contribution returned tax-free
Tax-free Compounding	✓	✓	✓
Required Minimum Distributions	✓		✓

Section 199A


Is it a Specified Service Business?
No
Is taxable income over the threshold amount?
No
Deduction = QBI x 20%
Yes
Over full Phase – in?
No
Deduction Reduced
Yes
Deduction equals lesser of:
• QBI x 20% or
• The greater of:
- W-2 wages x 50%
- W-2 wages x 25% + 2.5% of qualified property
Yes
Is taxable income over the threshold amount?
No
Deduction = QBI x 20%
Yes
Is taxable income over the full phase-in?
No
Deduction Reduced
Yes
No Deduction

Eligible Taxpayers

TYPES OF TAXPAYERS	THRESHOLD AMOUNT
Married persons	$ 364,200
All other taxpayers	$ 182,100

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Basics

"Income Deficit"

- The deduction also cannot exceed the lesser of
  - The "Combined QBI Amount," or
  - 20% x (total taxable income – capital gain)

- Combined QBI amount = deduction for each qualified trade or business ***PLUS*** **20% of REIT dividends and PTP income**

§ 199A, § 11011

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Personal Trainer Example

Roth Contributions & Conversions to Increase the 199A Deduction

- Your personal trainer, Tom, will make $100,000 (QBI) giving fitness lessons and nutritional advice
- He operates as a sole proprietor and just files a Schedule C to report his business income
- He diligently contributes to his IRAs and has done well in the market, but basically has no other sources of income

Personal Trainer Example

Roth Contributions & Conversions to Increase the 199A Deduction

- He will claim the $13,850 standard deduction for single filers and plans a $6,000 contribution to his IRA – in that case his taxable income will be about $80,150

You explain he will not be entitled to a full 199A deduction if his taxable income is too low

Taxable Income x 20% < QBI x 20%

Personal Trainer Example

Roth Contributions & Conversions to Increase the 199A Deduction

- You therefore advise Tom to consider Roth IRAs to increase his 199A deduction in 2023
- You explain that if Tom makes a Roth IRA Contribution instead of a Traditional IRA contribution he will be entitled to a greater QBI deduction.
- You also explain that if he makes a $13,850 Roth Conversion, he will be entitled to the full 199A deduction – because he raises his taxable income to equal his QBI.

Personal Trainer Example

Roth Contributions & Conversions to Increase the 199A Deduction

- Your simple advice increases Tom's deduction and allows him to save more for retirement on an after-tax basis

- His effective Roth IRA contribution and conversion rate will only be 17.6% [22% x (1-20%)]

Traditional v. Roth v. Life Insurance

It's all about marginal rates !

- If a business owner can claim 199A in full, their actual current rate is 80% of the scheduled tax rate
- This changes the mathematics of the Traditional v. Roth v. Life Insurance analysis we are familiar with

Traditional v. Roth v. Life Insurance

It's all about marginal rates !

Equal Rates at Contribution & Distribution
199A Doesn't Apply

	Traditional 401(k)	Roth 401(k)
Annual Savings	$ 20,000	$ 20,000
Less: Income Tax Cost (35%)	-	(7,000)
Net Balance	$ 20,000	$ 13,000
Growth Until Death	200%	200%
Account Balance @ Death	$ 40,000	$ 26,000
Less: Income Tax Cost (35%)	(14,000)	-
Net to Family	$ 26,000	$ 26,000

Traditional v. Roth v. Life Insurance

It's all about marginal rates !

Equal Rates at Contribution & Distribution
199A Applies

	Traditional 401(k)	Roth 401(k)
Annual Savings	$ 20,000	$ 20,000
Less: Income Tax Cost (80% of 35%)	-	(5,600)
Net Balance	$ 20,000	$ 14,400
Growth Until Death	200%	200%
Account Balance @ Death	$ 40,000	$ 28,800
Less: Income Tax Cost (35%)	(14,000)	-
Net to Family	$ 26,000	$ 28,800

Key Planning Ideas

- **Reduce Taxable Income below the threshold amount**
  - Tax-free bonds
  - Life insurance & annuities
  - Real estate investments
  - Oil & gas investments
  - Recognize losses
  - Avoid recognizing gains
  - Charitable contributions
  - Pension plan contributions
  - Increase payroll
  - Accelerate business expenses
  - Cost segregation studies
  - Captive insurance companies
  - Broaden ownership group to those with lower taxable income
  - Gifts to taxpayers with lower taxable income (e.g. children & trusts)

Key Planning Ideas

- **Increase QBI for those below the threshold amount**
  - Defer business expenses (e.g. insurance premium or property tax payment plans)
  - Defer acquisitions of new property eligible for 179 or bonus treatment
  - Reduce wages paid
  - Drop S-election to avoid owner's wage
  - Reduce leverage

Key Planning Ideas

- **Pass the "Wage" or "Capital" Test**
  - **Increase qualified property**
    - Acquire or improve property before year-end
    - Carefully consider whether items are capitalized or expensed
    - Understand what property will "roll-off" at year-end
  - **Increase Wages**
    - Employee bonuses
    - S-election
  - **REVIEW AND COMPUTE THE EFFECTIVENESS OF BOTH AGGREGATION ELECTIONS**

Roth Conversions

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Roth Conversions

2017 Tax Reform Refresher

TAX REFORM REPEALED THE ABILITY TO RECHARACTERIZE A ROTH CONVERSION

However, it is still possible to recharacterize a Roth contribution.

Mathematics of Roth IRA Conversions

- In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:
  - The annual growth rates are the same
  - The tax rate in the conversion year is the same as the tax rate during the withdrawal years

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

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

Mathematics of Roth IRA Conversions

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

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Mathematics of Roth IRA Conversions

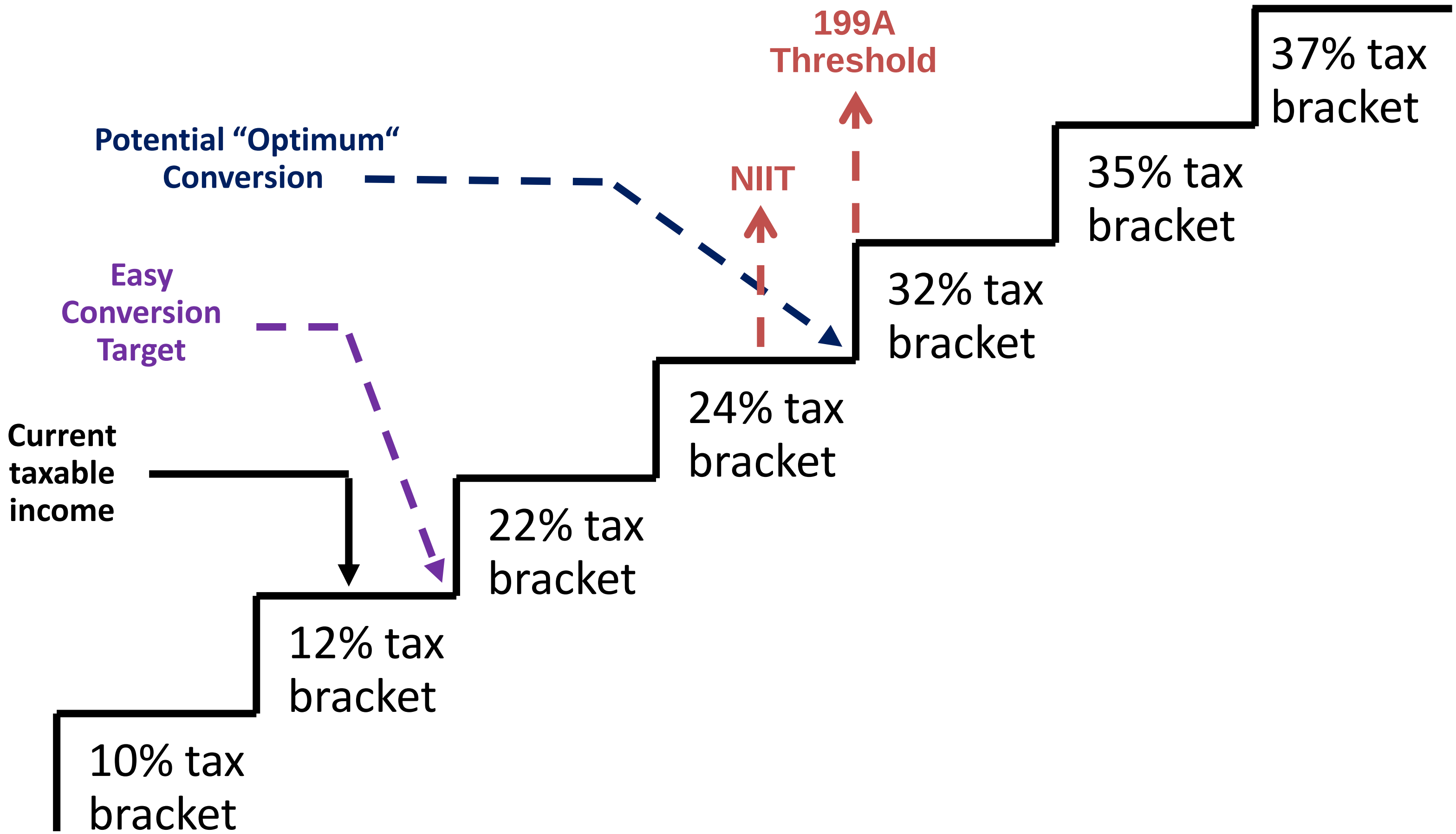
Reasons for converting to a Roth IRA

1. The taxpayer have special favorable tax attributes that need to be consumed such as charitable deduction carry-forwards, investment tax credits, NOLs, etc.…
2. The client expect the converted amount to grow significantly
3. Current marginal income tax rate is likely lower than at distribution
4. Cash outside the qualified account is available to pay the income tax due to the conversion
5. The funds converted are not required for living expenses, or otherwise, for a long period
6. The client expects their spouse to outlive them and will require the funds for living expenses
7. The client expects to owe estate tax

Mathematics of Roth IRA Conversions

- The key to successful Roth IRA conversions is often 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 3.8% Medicare “surtax”
  - Need to take into consideration phase-outs of tax-benefits
  - Need to take into consideration the impact of AMT

Mathematics of Roth IRA Conversions



Mathematics of Roth IRA Conversions

Administrative Issues

- Estimated taxes
- State and local taxes
- Cash reserves
- **Dollar cost averaged conversions**
- **Micro-conversions**

Retirement Account “DrawDown”

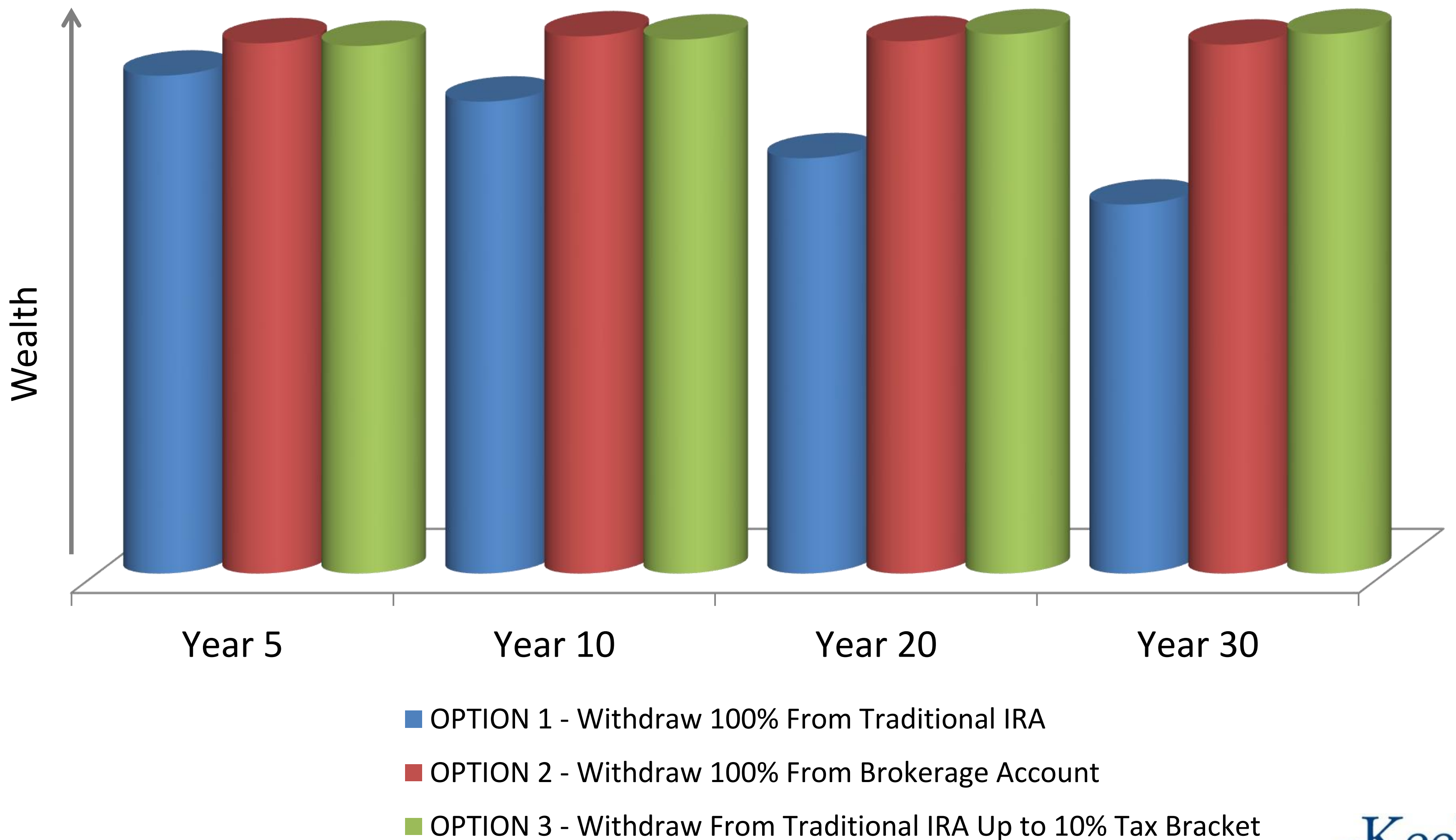
Retirement Account "DrawDown"

Distribution Planning

Perhaps one of the most important decisions a retiree must make is to determine from which retirement assets to withdraw funds to meet everyday living expenses.

Retirement Account "DrawDown"

Distribution Planning



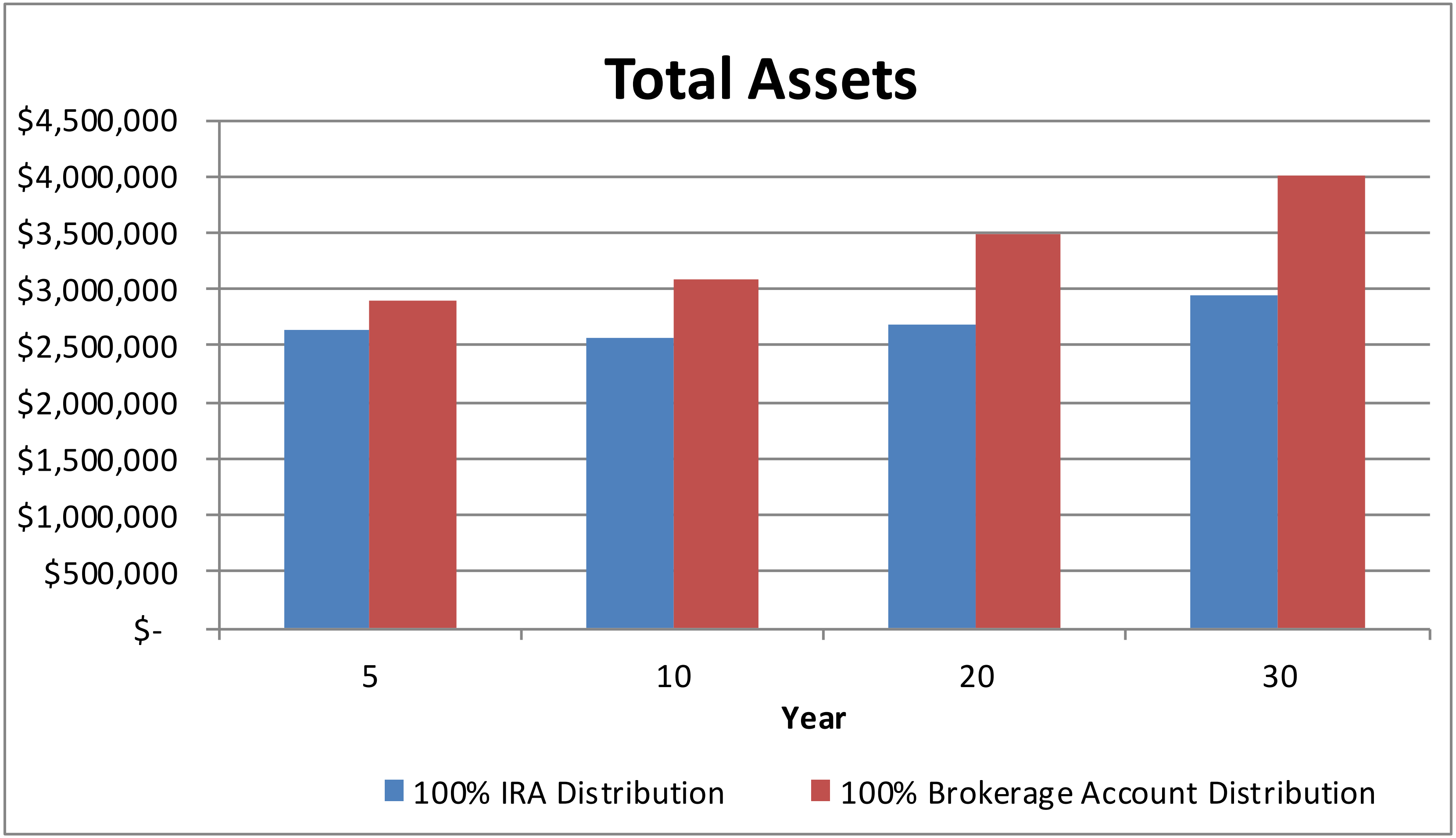
Retirement Account "DrawDown"

Distribution Planning

- Decision factors
  - Size of accounts
  - Investment mix / performance
  - Marginal income tax bracket
  - Time horizon

Retirement Account "DrawDown"

Value of Account Preservation – Example



OIL & GAS INVESTMENTS

Oil & Gas Investments

Key Code Sections

- Intangible Drilling Costs (IDCs) – IRC § 263(c)
- Exception to the Passive Loss Rules – IRC § 469(c)(3)
- IRC § 179 Deduction

Oil & Gas Investments

Overview

- One way to avoid having taxable income in a higher tax bracket or NII subject to the NIIT is by creating deductions
- Intangible drilling costs (IDCs) provide a large immediate income tax deduction (up to 85% of the initial investment)

Oil & Gas Investments

Example

- Carl is a single taxpayer with a salary of $100,000 per year
- In 2018, he sells X Corporation stock, with a basis of $100,000, for $500,000, recognizing a long-term capital gain of $400,000
- The first $100,000 of gain is taxed at 15%, the next $206,750 of gain is taxed at 18.8%, and the remaining $93,250 of gain is taxed at 23.8%
- **Oil & Gas Investment**
- Now Carl invests $375,000 in an oil and gas partnership that produces $50,000 of income each year from 2018-2021
- This produces a tax deduction of $300,000 in 2018, assuming 80% of the investment is deductible intangible drilling costs (.8 x $375,000)
- This eliminates all of Carl's income in the 18.8% and 23.8% brackets for 2018

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SUBSTANTIAL SALE CRT

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.

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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

Substantial Sale CRT

Taxation

- The donor will NOT realize gain or loss when property is transferred to the trust
- However, the donor may be required to recognize gain if:
  - Property transferred is subject to indebtedness that exceeds basis
  - Donor 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

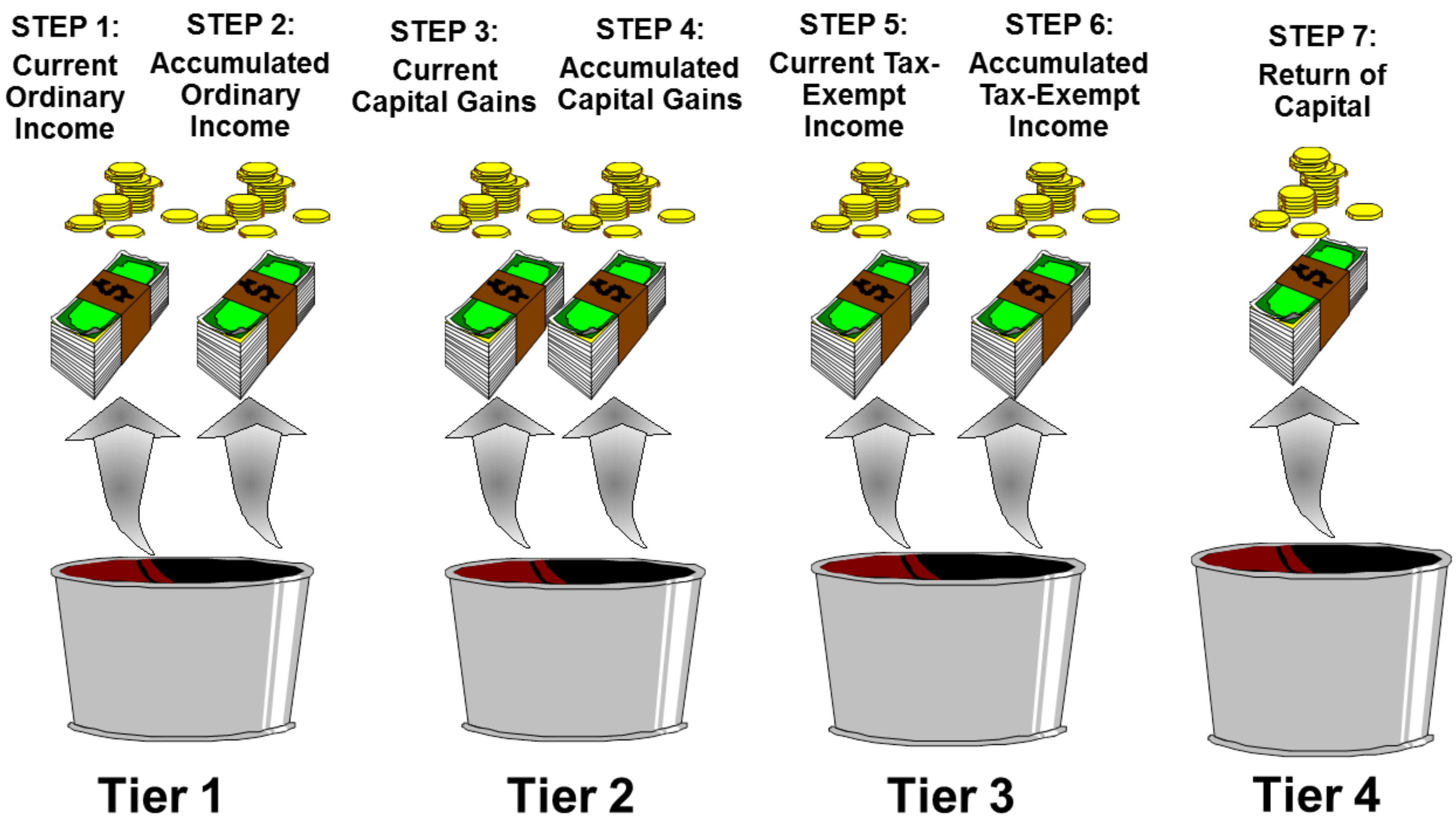
Substantial Sale CRT

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

Substantial Sale CRT

Taxation (continued)



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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

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Substantial Sale CRT

Strategy

Donor
(Income Beneficiary)

Transfer of highly appreciated assets

CRT

Annual (or more frequent) payments for life (or a term of years)

Donor receives an immediate income tax deduction for present value of the remainder interest (must be at least 10% of the value of the assets originally contributed)

At the end of the trust term, the charity receives the residual assets held in the trust

Public Charity
(Remainder Beneficiary)

CHARITABLE LEAD TRUSTS

Effective for those without charitable intent?

Charitable Lead Trusts

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.

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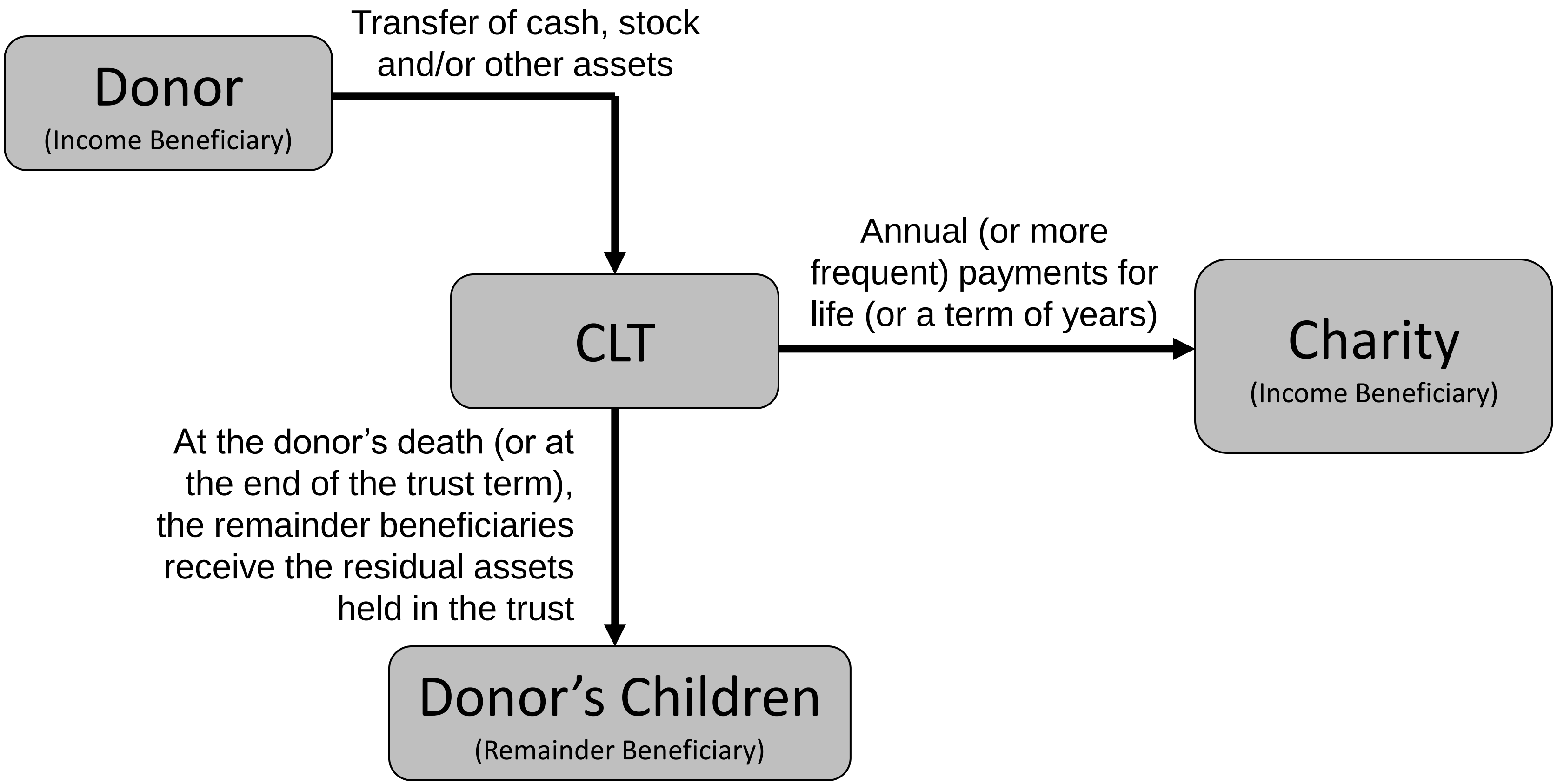
Charitable Lead Trusts

Overview



Charitable Lead Trusts

Types

- Charitable Lead Annuity Trust (CLAT)
  - 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)
- Charitable Lead Unitrust (CLUT)
  - The charitable beneficiary receives 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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Conclusion

Year-end Planning

A Checklist of Ideas to Prepare for a New Year

- ❑ Bracket Management
  - ❑ Accelerate bonuses to avoid rate increases
  - ❑ Accelerate recognition events to avoid rate increases
  - ❑ Defer business expenses to capture a greater benefit if rates increase
  - ❑ Consider what reinstatement of the AMT would mean

- ❑ Itemized Deduction Timing
  - ❑ Carefully consider property tax payments
    - ➢ Defer to capture a greater benefit due to higher rates
    - ➢ Defer in-case the $10,000 SALT deduction cap is repealed
    - ➢ Accelerate to avoid additional itemized deduction limits
  - ❑ Carefully consider charitable contribution timing:
    - ➢ Defer to capture a greater benefit due to higher rates
    - ➢ Accelerate to avoid additional itemized deduction limits

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Year-end Planning

A Checklist of Ideas to Prepare for a New Year

- ❑ Gain & Loss Harvesting
  - ❑ Harvest gains to avoid rate increases
  - ❑ Defer harvesting losses to offset rate increases
  - ❑ Consider flexible gain recognition strategies
- ❑ Retirement Planning
  - ❑ Roth conversions before rates increase
  - ❑ NUA rollout before rates increase
  - ❑ Diversify concentrated positions before rates increase
- ❑ Executive Planning
  - ❑ Reconsider NQCD funding to avoid rate increases & increased payroll taxes
  - ❑ Consider ISO exercise in case the AMT returns in-force
  - ❑ Consider NQSO exercise to avoid rate increase & increased payroll tax
- ❑ Estate Tax Planning
  - ❑ Consider large lifetime gifts
    - ➢ Capture the large estate tax exemption
    - ➢ Avoid a forced recognition event

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