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Taxation - Income, Estate, and Gift

The Roth IRA conversion decision.

By Robert Keebler, CPA/PFS, MST, AEP® (Distinguished)

Traditional Individual Retirement Accounts (IRAs) and Roth IRAs provide tax breaks in different ways. Contributions to traditional IRAs are generally tax deductible, and growth is tax deferred, but withdrawals are taxable as ordinary income.[1] By contrast, contributions to a Roth IRA are not tax deductible, but growth and qualified withdrawals are tax free.[2]

The Roth IRA Conversion Decision

There will often be an economic advantage in converting a traditional IRA to a Roth IRA, but not in all cases. In deciding whether to do a Roth IRA conversion, taxpayers must analyze the tradeoff between paying current tax on the amount transferred and avoiding tax on later distributions from the account. The analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion to the taxpayer's expected marginal income tax rate when distributions are received. Note the following general rules.

- If the tax rate is lower at the time of conversion than at the time distributions are received, a Roth conversion will be favorable.
- If the tax rate is substantially higher at the time of conversion than the rate when distributions are received, a Roth conversion will be unfavorable.
- If traditional IRA assets are used to pay the conversion tax and the tax rate is the same at the time of conversion as at the time of distributions, converting will be neutral.
- If "outside assets" can be used to pay the conversion tax, a Roth conversion will be favorable even when the tax rate at the time of conversion is slightly higher than at the time distributions are received. The extent to which this is true depends on the difference between the pre-tax rate of return in the IRA and the after-tax rate of return of the outside assets.

These rules are illustrated in the following, somewhat simplified, examples. (All the examples assume that IRA assets are used to pay the conversion tax.)

Example 1: Art, a married taxpayer filing jointly, has $50,000 in a traditional IRA. Assume that the $50,000 will double in value by the time Art retires and that he takes a lump sum distribution at that time. Assume further that Art is currently in the 24% marginal income tax bracket. The chart on the following page compares the net after-tax wealth realized from converting with not converting, assuming his marginal tax rate:

- Drops to 22%,
- Stays the same, or
- Increases to 32%.

Paying the Conversion Tax with Outside Funds

As noted above, paying the conversion tax with outside funds significantly

1 It is possible to make a non-deductible contribution to a Traditional IRA as well, and such amounts may generally be withdrawn free of income tax, subject to certain ordering rules.

2 To be a qualified withdrawal from a Roth IRA, a distribution must generally be made after the later of: (1) when a taxpayer reaches age 59½, or (2) the end of the five tax-year period beginning with the year of the first contribution.

The Roth IRA Conversion Decision (Example 1)

	Marginal income tax rate drops to 22%		Marginal income tax rate remains 24%		Marginal income tax rate increases to 32%	
	Convert	Don't convert	Convert	Don't convert	Convert	Don't convert
Beginning value	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Current tax	$12,000	0	$12,000	0	$12,000	0
Amount remaining	$38,000	$50,000	$38,000	$50,000	$38,000	$50,000
Value at retirement	$76,000	$100,000	$76,000	$100,000	$76,000	$100,000
Tax payable	0	$22,000	0	$24,000	0	$32,000
Net amount	$76,000	$78,000	$76,000	$76,000	$76,000	$68,000

improves the economic result of a Roth conversion. This might make a Roth conversion favorable even if the tax rate is higher at the time of conversion than it is when distributions are received.

Example 2. Beth is a single taxpayer with a 30% combined federal and state income tax bracket in 2018. She has $50,000 in a traditional IRA and $15,000 of liquid assets in a side fund, which are available to pay the taxes from a Roth IRA conversion if Beth chooses to do one. Assume that the assets in the IRA will quadruple in value by the time Beth retires in 25 years, but the side fund will only triple in value because it is subject to tax. At the end of the 25-year period, Beth will receive a distribution of the full amount in the IRA and will be in a 25% combined federal and state tax bracket. The chart below compares the net amount realized for the Roth IRA conversion decision.

Under these facts, a Roth IRA conversion results in $5,000 more of

Paying the Conversion Tax with Outside Funds (Example 2)

	No conversion Leave assets in Traditional IRA.	Roth IRA conversion Use side fund to pay conversion tax.
Beginning balance	$50,000	$50,000
Conversion tax	0	$15,000
Value of IRA after conversion tax	$50,000	$50,000
Value after 25 years	(4 x $50,000)= $200,000	(4 x $50,000)= $200,000
Tax on distribution	$(50,000)	0
Amount after distribution tax	$150,000	$200,000
Plus value of side fund	(3 x $15,000) = $45,000	(eliminated to pay conversion tax) 0
Total net after-tax wealth	$195,000	$200,000

after-tax wealth than not converting, even though the tax rate drops from 30% to 25%. In effect, the taxpayer is able to pack more value into the IRA by paying the conversion tax with outside funds, which grow faster inside the IRA than they would if they remained in the taxable side fund.

Other Factors Favoring a Roth IRA Conversion

Even if a Roth IRA conversion doesn't produce greater net wealth in the basic calculation as illustrated above, there may be other important advantages to a Roth:

- Can make contributions after age 70½ (if the taxpayer has earnings in the year of the contribution, §408A(c)(4)).
- No required minimum distributions (RMDs) starting at age 70½.
- Tax-free income in retirement (Adjusted Gross Income is therefore lower, which offers income tax benefits elsewhere).
- Facilitates wealth accumulation for heirs if the account owner doesn't need the money in the Roth IRA.
- Tax-free withdrawals for beneficiaries after the death of the IRA owner.
- Hedge against possible future increases in income tax rates.

Note that taxpayers with favorable tax attributes such as charitable deduction carry-forwards, investment tax credits or expiring net operating losses, may be able to efficiently utilize these attributes to reduce the effective tax rate on a Roth conversion.

The decision to effect a Roth conversion is complex and depends on a careful analysis of numerous factors. With the help of astute advisors, however, many individuals with traditional IRAs may stand to benefit significantly from considering such a strategy.

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Business Planning

Business entity selection after the Tax Cuts and Jobs Act of 2017.

By Eva Stark, JD, LL.M.

When thinking about setting up a new business, aspiring business owners will discover that state laws recognize numerous business entities. These entities can include corporations (including professional corporations), limited liability companies (including professional LLCs or series LLCs), partnerships (including limited partnerships, limited liability partnerships, limited liability limited partnerships or general partnerships) and others. The type of activity the business will conduct, the laws governing the relationship between co-owners, and the laws governing liability and other issues between owners and third parties will all be key factors for consideration. The federal income tax treatment of the various entities will also likely rank highly on the list of issues to consider.

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The Tax Cuts and Jobs Act of 2017 (TCJA)

While state law business-entity options are numerous, the options are more limited when it comes to federal income taxation. A business entity will generally be taxed as one of the following:

- C corporation,
- S corporation, or
- Partnership (if there is more than one owner) or disregarded entity (if there is a single owner).

Of these, all except the C corporation are taxed as a form of "pass-through" entity. The federal income taxation of these entities changed significantly with the TCJA, and such changes will not only affect newly created entities but existing businesses as well.

Impact on C corporations

The tax burden of many higher-income C corporations has been permanently reduced by the TCJA, but "double taxation" (taxation at the entity as well as the shareholder level) remains for all C corporations. The TCJA replaced the graduated marginal tax rates ranging from 15% to 35% with a flat rate of 21%. The TCJA also repealed the corporate alternative minimum tax. On the shareholder level, C corporation owners remain subject to a second level of taxation when income is distributed from the corporation, which can be 0%, 15% or 20%. Dividends may additionally be subject to a 3.8% tax on net investment income. As a result, even with reduced rates, C corporations remain a relatively unattractive option from

an income tax perspective. This may be especially true for lower-income C corporations which previously enjoyed effective tax rates of under 21% (typically C corporations with roughly $90,000 of taxable income or less).

Impact on pass-through entities

The tax burden of the owners of certain pass-through entities has also been reduced by the TCJA, but only temporarily—until January 1st, 2026.[1] Unlike C corporations, pass-through entities do not pay taxes on the entity level, although S corporations and partnerships file entity-level information returns.

The TCJA benefits the owners of pass-through entities in two ways. First, individual tax brackets have been adjusted so that income flowing through to the owners of pass-through entities is generally taxed at lower rates. Second, the TCJA created a new deduction for pass-through business income, up to the lesser of 20% of taxable income or the combined qualified business income of the taxpayer.[2]

Generally, owners of all pass-through entities may claim the deduction so long as they report taxable income of less than $315,000 for married filing jointly or $157,000 for all other filers. Above this income level, limitations begin to be phased in, which reduce the deduction based on (i) wages paid by the company, (ii) company assets owned and (iii) the type of business the company is engaged in (i.e., whether the business is a specified service business). Limitations fully apply once a business owner's taxable income reaches $415,000 for married filing jointly or $207,500 for single taxpayers. Without diving into the technicalities of the TCJA, the wage limitation sets a ceiling on the business income that could

qualify for the 20% deduction at 50% of wages paid. The asset limitation sets a ceiling to business income that could qualify for the 20% deduction at 25% of wages paid plus 2.5% of the unadjusted basis of qualified property the business owns. On the other hand, the specified service business limitation completely eliminates the 20% deduction on qualified business income for specified service businesses (including businesses that provide health, law, engineering, accounting, actuarial science, financial, brokerage and certain other services) once the taxpayer's income reaches a level of income where the limitations are fully phased in ($415,000 for married filing jointly or $207,500 for single filers).

Choosing among pass-through entities

One of the most often-touted benefits of S corporations over other pass-through entities has been that S corporations can pay W-2 wages to owners which in turn may reduce the owners' payroll tax exposure in certain circumstances. Unlike the owners of other pass-through entities, S corporation owners are generally only subject to payroll taxes on the W-2 wages they receive—provided that the wages are reasonable. Profits an S corporation owner receives that are in excess of his or her W-2 wages are generally only subjected to income tax and escape payroll taxes. Owners of partnerships or disregarded entities, on the other hand, must generally pay payroll taxes on all of their business income.

Under the TCJA, a pass-through entity's ability to pay W-2 wages may also affect to what extent, if any, the pass-through entity may benefit from the potential 20% deduction on qualified business income. W-2 wages paid generally reduce qualified business income (resulting in a lower deduction, all else equal) but also increase the wage limitation ceiling, where such ceiling is applicable (resulting in a higher deduction, all else equal). This feature may make the disregarded entity or partnership a relatively more attractive option for certain lower-income business

1 Without future changes in the law, certain provisions of the Tax Cuts and Jobs Act will sunset on December 31, 2025. These include many provisions affecting pass-through business entities and individuals.

2 I.R.C. Section 199A.

Example of 20% Deduction for Pass-Through Entities (Lower Income vs. Higher Income)[3]

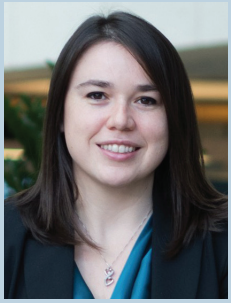
	Lower Income Business			Higher Income Business		
	S-Corporation	Partnership	Disregarded Entity	S-Corporation	Partnership	Disregarded Entity
Business income	$200,000	$200,000	$200,000	$1,000,000	$1,000,000	$1,000,000
Wages (W-2 only)	$150,000	N/A	N/A	$400,000	N/A	N/A
Guaranteed payments	N/A	$0	N/A	N/A	$400,000	N/A
Net business income	$50,000	$200,000	$200,000	$600,000	$600,000	$1,000,000
Qualified business income	$50,000	$200,000	$200,000	$600,000	$600,000	$1,000,000
Maximum potential deduction (20% QBI)	$10,000	$40,000	$40,000	$120,000	$120,000	$200,000
50% wage limitation	N/A	N/A	N/A	$200,000	$0	$0
Potential deduction	$10,000	$40,000	$40,000	$120,000	$0	$0

owners to whom the wage or asset limitations may not apply, while making the S corporation a relatively more attractive option for higher income business owners who are subject to the wage or asset limitation. The table above illustrates how W-2 wages paid may affect the potential 20% deduction on qualified business income for three types of pass-through entities.

Conclusion

Selecting the right business entity is a difficult decision that every aspiring business owner must make. Not only must state laws be considered, but tax implications as well. Recent tax law changes may create additional complexity not only for aspiring business owners but also for the owners of existing businesses that are affected. The optimal choice of entity decision will depend on many variables, both tax and non-tax related.

As a result, before establishing a business entity or changing the tax status of an existing entity, owners should thoroughly explore such variables with an experienced attorney or CPA.



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3 Assumes that business owner is married filing jointly with no other income. Partnerships and disregarded entities cannot pay W-2 wages to owners. While partnerships may choose to make guaranteed payments, guaranteed payments are not W-2 wages, do not count toward the 50% wage limitation, and are not counted as qualified business income. Assumes business has no qualified property.

Taxation - Income, Estate and Gift

Planning issues and considerations for non-U.S. citizens.

By Robert Ahearn, BSBA, JD, LL.M., CFP®, CLU®, ChFC®, CRPC®

Many businesses in the United States utilize H1B, L-1A and other visa programs to fill needs for specialty occupations. As such, more and more people, as well as their spouses, children and other close family members (such as a parent who accompanies the nuclear family), are not U.S. citizens. Planning for non-U.S. citizens is more complicated than planning for U.S. citizens.

This provides a competitive advantage to the financial professional who becomes educated on estate planning for non-U.S. citizens.

Consider residency and situs

Resident aliens, persons who are foreign nationals residing in the United States (including the vast majority of green card holders), are taxed on their world-wide assets for estate and gift tax purposes, just like U.S. citizens. Non-resident aliens, persons who are foreign nationals residing outside of the United States, are only taxed on their U.S.-situs assets. There are certain assets that are not considered to be U.S.-situs assets, including bank accounts, certificates of deposits, municipal bonds, and stock of foreign (non-U.S.) corporations. A life insurance policy, where owner and insured is the same non-resident alien, is not considered a U.S.-situs asset and as such, is not subject to U.S. estate tax.

Different gift and estate tax treatment

A U.S. citizen and a resident alien are treated the same for both federal estate and gift tax (as well as the generation-skipping transfer tax), with the applicable exemption amount being $11,400,000 per person ($22,800,000 per married couple) in 2019. This amount is adjusted for inflation annually, with an estate tax rate of 40% on assets in excess. A non-resident alien (a person who is not domiciled in the United States at the time of death or gift), however, may transfer only $60,000 of assets free of estate and gift tax. This $60,000 exclusion amount was set in 1988, and has not been adjusted for inflation since that year.

The exclusion amount for a non-resident alien may be greater than $60,000 if the non-resident alien is a domiciliary of a country that has negotiated a separate or combined estate and gift tax treaty with the United States.[1]

Some nations that lack an estate tax, such as Canada and Israel, have estate tax provisions within their U.S. income tax treaty. Each treaty is distinct with nuances that can surprise planners.

Planning strategies

If a non-resident alien is from a country without an estate and/or gift tax treaty with the United States, then that person will most likely need life insurance to pay estate tax on all

1 The estate tax treaty nations include Australia, Austria, Denmark, France, Germany, Japan, Sweden, and United Kingdom. The gift tax treaty nations include Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland and United Kingdom.

U.S.-situs assets where the aggregate value exceeds $60,000.

With married couples, planning can be even more complex. Where a spouse is not a U.S. citizen, no marital deduction is available for estate tax purposes for transfers made either directly to, or in trust for, the non-U.S. citizen surviving spouse. If the decedent spouse's estate exceeds the applicable exemption amount, there is likely to be an estate tax that cannot be deferred until the death of the surviving spouse.

However, the Internal Revenue Code (IRC) provides for a Qualified Domestic Trust (QDOT) that enables deferral of federal estate tax on property passing into the QDOT for the non-U.S. citizen spouse at the U.S. citizen spouse's death. The use of a QDOT merely delays imposition of the estate tax, it does not eliminate it. The income paid from the QDOT, however, escapes estate tax (though it is still subject to income tax).

With regard to gifts from a U.S. citizen spouse to a non-U.S. citizen spouse, the IRC provides what many planners call a "super-annual exclusion." Annual gifts to a non-U.S. citizen spouse that otherwise qualify for the annual gift tax exclusion can be made in amounts of up to $155,000 in 2019 (subject to annual adjustment for inflation). This super-annual exclusion may be leveraged using a popular technique. The U.S. citizen spouse makes gifts to the non-U.S. citizen spouse each year of an amount up to the super-annual exclusion amount. The non-U.S. citizen spouse then leverages this super-annual exclusion gift by purchasing insurance on the life of the U.S. citizen spouse using most or all of the gift amount.

Ultimately, the death benefit proceeds would provide financial security to the non-U.S. citizen that would be free from the U.S. citizen spouse's creditors. Such proceeds also could be used to purchase assets from the estate of the U.S. citizen spouse in order to obtain a "stepped-up" basis for those assets.

Additionally, an opportunity exists to utilize more than the super-annual exclusion amount if, in addition to the super-annual exclusion gift itself, the U.S. spouse also makes an interest-free loan to the non-U.S. citizen spouse, which is then used for the purchase of life insurance. Such a below-market interest rate loan is possible as, under the IRC, a husband and wife are treated as one person, and a person cannot make a loan to him or herself.

There is, of course, much more to know where a U.S. citizen or resident alien owns property outside the United States, or where a non-resident alien owns property within the United States, so clients should consult with an estate planning attorney with experience in planning for non-U.S. citizens.

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