



Effective Wealth

A Newsletter of Rothstein Kass®

First Quarter 2010

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Different economic times require taxpayers to take different approaches to reducing their tax burden and managing family wealth. Over the past few years, we have seen interest rates at or near historically low levels. The current interest rate environment provides substantial opportunities for transferring wealth.

There are many techniques for maximizing wealth transfer, while minimizing transfer costs. The following strategies will focus on those methods that are best suited for today's low interest rate environment.

THE RATES

Every month, the Internal Revenue Service (IRS) publishes the Applicable Federal Rates (AFRs), which are the base interest rates for use in transactions (e.g., minimum interest rates on loans). The rates for February 2010 are as follows:

Short-term AFR	0.72%
Mid-term AFR	2.82%
Long-term AFR	4.44%

The short-term AFR is used for transactions with terms of up to three years; the long-term AFR is used for transactions with terms of more than 9 years; the mid-term AFR is used for transactions in between.

The IRS also publishes the statutory rate for use in valuing many wealth transfer transactions. This rate, defined in the Internal Revenue Code section 7520 (and called the "7520 Rate"), is 3.4% for February 2010. The 7520 Rate was at historic lows for all of 2009.

LOANS AND ANNUITIES

Loans and annuities all benefit from the current low interest rates in the most basic way: the base interest rate required by the IRS is based on the low rates in the general market. There are three

simple ways to transfer family wealth through loans and annuities.

Family Loans

The simplest transaction which benefits from low interest rates is the family loan. As the name suggests, the loan is between family members. It can have any negotiated term, and the interest rate must be at least the AFR (based on the term of the loan). If parents make family loans to their children for five years, they must charge interest at the mid-term AFR (2.82% in February 2010). If the children can invest the proceeds at 10%, they will net 7.18% after the interest payments, and may receive tax deductions for the interest expense.

SCIN

A Self-Canceling Installment Note (SCIN) is like a basic family loan, but contains the provision that the loan is canceled in the event that the lender dies during the term of the loan. Because of this cancellation provision, the stated interest rate of the loan will be higher than the AFR (to include a risk premium). Even with the risk premium, the interest rate may be lower than the rates available from third party lenders, depending on the age of the lender.

Private Annuities

A Private Annuity is an arrangement where a parent transfers assets to a child, and in return, the child agrees to pay the parent an annuity for the remainder of the parent's life. There is no gift if the present value of the annuity is equal to the amount of the assets originally transferred (based on the life expectancy of the parent, and the 7520 Rate). Because of the low interest rates, the required annuity is low, and more of the principal is likely to remain with the child.

TRUST ARRANGEMENTS

There are three common trust arrangements used for transferring wealth to take advantage of low interest rates.

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GRATs

A Grantor Retained Annuity Trust (GRAT) is an arrangement where property is placed in the trust, and an annuity from the trust is paid back to the grantor. The annuity is valued for transfer tax purposes using the government's 7520 Rate (3.4% at February 2010). The annuity is calculated so that the present value of the annuity is equal to the amount of property placed into the trust. If \$1,000,000 is put in the trust, and the grantor receives an annuity with a present value of \$1,000,000, then there is no gift to the trust for transfer tax purposes. (In this example, a three-year GRAT is required to make annuity payments of \$356,252 each year.)

At the end of the trust term, the property that remains in the trust can be transferred to the grantor's children, tax-free. What will be left in the trust? If the GRAT principal can earn 10% but is only required to pay 3.4% to the grantor, then the trust property will yield 4.8% (after adjusting for cash flows). A GRAT is successful when the property in the trust returns more than the 7520 (“hurdle”) Rate.

GRATs require the grantor to recognize income earned by the trust, and pay tax on that income, however, the tax payment should really be considered an additional (tax-free) gift to the children. The GRAT is includible in the grantor's estate, if he dies during the term, but the property would have been included in his estate, anyway, if the transaction had not occurred.

The current trend is to set-up short-term GRATs, and roll-over the annuity payments received into another short-term GRAT. Shorter terms are favored because the grantor is more likely to survive a short-term GRAT (especially an older grantor). Longer-term GRATs are more likely to “fail” if the property suffers losses in the early years of the GRAT. (A GRAT “fails” when the principal is returned to the grantor, and nothing passes to the children.)

There is consideration in Washington to change the GRAT rules to require minimum terms of 10 years. In today's current interest rate environment, longer-term GRATs would certainly benefit by locking in the current low hurdle rate.

SDGT

A Sale to a Defective Grantor Trust (SDGT) involves the grantor creating a trust and contributing seed capital. The trust will then proceed to buy property from the grantor with a minimum

down payment (10%), and sign an interest-only note for the balance of the purchase price. If the term of the note is from three to nine years, then the interest rate must be the mid-term AFR (2.82% at February 2010).

The annual payments to the grantor (the interest payments) are much lower than the GRAT option, and the property stays in the trust longer. While a GRAT requires annual principle and interest payments, a sale arrangement may only require annual interest payments (with a balloon principle payment due at the end of the term).

Like the GRAT, the grantor recognizes the income earned by the trust, and pays the tax on that income. However, if the grantor dies during the term of the note, it is not clear what is includible in the grantor's estate, the promissory note or the full value of the trust.

CLAT

A Charitable Lead Annuity Trust (CLAT) is an arrangement where property is placed in trust, and annuities are paid to one or more charities during the term of the trust. At the end of the term, the remainder is distributed to the trust's beneficiaries, tax-free.

While a GRAT pays the annuity to the grantor, the CLAT pays the annuity to charities. The GRAT eliminates transfer tax by fine-tuning the annuity payment to the grantor; the CLAT eliminates transfer tax by fine-tuning the annuity payment to the charity. A CLAT can also benefit from having a long life, and locking in today's low interest rates.

CONCLUSION

Today's low interest rate environment may provide tremendous estate planning opportunities. As the economy improves, we are likely to see interest rates increase. Now is the time to consider utilizing the benefits of leveraging the current low interest rate environment in your estate planning. The strategies discussed above contain various requirements and have important tax considerations. All of these arrangements can be more fully explained and elaborated upon by a Rothstein Kass professional advisor. [®]

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2010 Roth IRA Conversion Strategies and Opportunities

Prior to 2010, individuals with modified adjusted gross income (AGI) of \$100,000 or more and married taxpayers filing separate returns were prohibited from converting traditional IRAs to Roth IRAs.

Beginning in 2010, the \$100,000 AGI limitation on conversions of traditional IRAs to Roth IRAs is completely repealed. Taxpayers with adjusted gross income in excess of \$100,000 will be allowed to convert traditional IRAs to Roth IRAs. The filing status restrictions are also eliminated allowing married taxpayers filing separate returns to convert, as well.

When considering to convert to a Roth IRA, it is important to note that there is a current tax cost associated with converting. The conversion to a Roth IRA triggers taxable income in the year of conversion. Individuals who convert in 2010 will have the choice of recognizing their taxable conversion income in 2010, or splitting the taxable conversion income equally between the next two tax years (2011 and 2012). Splitting allows taxpayers to pay the taxes on the converted amount over a two year period. If splitting is elected, the income will be taxed at the rates in effect for 2011 and 2012.

Deciding if it's prudent to make the conversion involves making assumptions on what future tax rates will be. President Obama has proposed, and Congress is expected to enact, legislation that restores the top two pre-2001 marginal income tax rates (36 and 39.6 percent) after 2010. If tax rates are going to rise (as has been speculated pending health care reform), it may be beneficial for individuals in higher income brackets to pay the tax in 2010 at the lower rates, instead of in 2011 and 2012.

There are significant tax and financial issues that should be considered when determining whether to convert your traditional IRA or other eligible retirement plans, such as profit sharing 401(K) or SEP plan to Roth IRAs. Among the items to consider are:

Do you have enough liquidity using non-IRA assets to pay the tax due on the conversion income?

Do you anticipate being in a higher tax bracket in the future, when you may begin withdrawing from the Roth IRA?

If you plan to take distributions from the Roth IRA in the future, do you have sufficient time before you plan to take withdrawals to allow

the assets to grow tax-free and recoup the taxes that were paid on the conversion?

Your age and the age of non-spouse beneficiaries, if any, of your Roth IRAs. The longer the Roth IRA remains intact, the greater the potential accumulations of tax-free assets in the fund.

Some of the major advantages of a Roth IRA over a traditional IRA are:

Provided certain requirements are met, Roth IRA distributions are tax-free. Traditional IRA distributions are tax-deferred and taxable in the years withdrawals are received.

Roth IRAs are not subject to the required minimum distribution (RMD) rules that apply to traditional IRAs. Roth IRA account holders who have reached age 70^{1/2} are not required to begin taking distributions, allowing the funds to continue to grow tax-free until they are needed or are passed to their heirs.

If you intend to take advantage of the Roth IRA conversion opportunity in 2010, you may want to consider utilizing some of the following strategies:

If you are able to make deductible IRA contributions for 2009, do so. (Deductible and non-deductible contributions to an IRA can be made for 2009, until April 15, 2010.) This can help to reduce your 2009 tax liability, and if you convert to a Roth IRA in 2010, you will not have to pay back the 2009 tax savings until 2011 if you elect to pay the tax over the two-year period. However, this strategy would not be appropriate if you expect your tax rates to increase.

Should you consider making non-deductible IRA contributions for 2009, you can transfer the amounts contributed to the non-deductible IRA into a Roth IRA in 2010, at no additional tax cost.

Consider converting to a Roth IRA now if the balance in your traditional IRA account has depreciated due to stock market declines. If the value of your IRA account declines further, before you file your 2010 tax return, you have the option of "recharacterizing" your Roth IRA conversion back to a traditional IRA, and then converting to a Roth IRA in 2011.

Roth IRA Recharacterization

If you convert a traditional IRA into a Roth IRA and suffer a decline in the value of your investments, you can *recharacterize* or *undo* your conversion. For example, if you converted \$250,000 from a

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"Deciding if it's prudent to make this conversion involves some very important tax planning."

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traditional IRA and the value subsequently declines to \$150,000, you can reverse the conversion and turn your Roth IRA back into a traditional IRA. For tax purposes it is treated as though the conversion never occurred.

Should you wish to reconvert the Roth IRA that you recharacterized to a traditional IRA back to a Roth IRA, you must wait until the beginning of the taxable year following the year of the original conversion, or 30 days after the recharacterization of the Roth IRA to a traditional IRA, whichever is longer. The recharacterization can be accomplished by filing the appropriate paperwork with the IRA custodian. Upon recharacterization, if you have already filed your tax return, you will need to file an amended tax return to obtain a refund of the overpaid taxes. If you recharacterize and you haven't filed your income tax return you will need to file your tax return by the original or extended due date without including the original conversion amount in income. It would be advisable, if you are considering a conversion of a traditional IRA to a Roth IRA, to extend your tax return in order to allow an additional six month look-back period for recharacterizing.

The recharacterization rules should be carefully considered when making the decision to split the taxable conversion between 2011 and 2012. The payment of the tax due on the taxable conversion may not be due until April 15, 2012 for the 2011 portion of the split, and April 15, 2013 for the portion of the 2012 split. The deadline for recharacterization for 2010 conversions would still be October 15, 2011. If the converted assets retain their value past the October 15 deadline and then drop, you may find yourself in a financial bind if you do not have enough cash available to pay the conversion tax.

When converting from a traditional IRA to a Roth IRA you may wish to consider establishing separate Roth IRAs for different asset classes. Setting up separate Roth accounts will allow you to segregate and focus on the performance of specific areas of your portfolio and which asset classes you might consider recharacterizing back to traditional IRAs due to a decline in value, while leaving the remaining assets that are performing well in the Roth accounts to continue building tax free. [®]

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