



**COX  
HODGMAN &  
GIARMARCO**

Fifth Floor Columbia Center  
201 West Big Beaver Road  
Troy, Michigan 48084-4160  
(248) 528-2200  
Fax (248) 689-8107

ATTORNEYS AND COUNSELORS AT LAW  
ESTATE PLANNING DIVISION  
WWW.DISINHERIT-IRS.COM

WINTER 1998

DETROIT • LANSING • TROY

Editor: Julius H. Giarmarco, J.D., L.L.M.  
Associate Editor: Salvatore J. LaMendola, J.D.

# Roth IRAs - Is Conversion A Good Idea?

## Introduction.

Since the creation of the new "Roth IRA" by the Taxpayer Relief Act of 1997, one of the big questions confronting planners is whether or not their clients should convert their existing IRAs to the new Roth IRA. This article will focus on some of the issues surrounding this decision.

## Who is eligible?

To become eligible for a Roth IRA conversion, a taxpayer must have an adjusted gross income ("AGI") below \$100,000 in the year of conversion. This limitation applies to both single taxpayers and married couples who file a joint tax return. Married taxpayers who file separate returns do not qualify for conversion regardless of their AGI. Taxpayers who expect to exceed the \$100,000 limit and wish to convert to a Roth IRA in 1998, should consult with their accountants regarding the various techniques available for reducing their AGI and/or deferring income into future years.

## What are the tax implications at the time of conversion?

When a traditional IRA is converted to a Roth IRA, the entire IRA balance will become taxable to the account holder in the year of conversion. However, if conversion takes place in 1998, the income taxes can be spread over a four year period. These "up front" income taxes present the largest obstacle to conversion since many people will not have the cash available outside the IRA to pay the taxes. Taxes should not be paid from the IRA because doing so reduces the advantages of conversion and because the 10% early withdrawal penalty may be triggered. In order to gain the maximum advantage of conversion, taxes should be paid from an outside source of funds. It should be noted, however, that the sale of appreciated assets to pay the income tax will generate additional capital gains taxes. Therefore, it is important to use a comprehensive software package which can compile the various taxes involved and produce an accurate analysis.

## What are the tax implications of distributing funds from a Roth IRA?

Contributions and earnings may be distributed from a Roth IRA income tax free if at least five years have past since the first contribution and one of the following requirements are met: (1) the withdrawn funds are used for a first-time home purchase and the amount withdrawn for such purpose does not exceed \$10,000, (2) the taxpayer is age 59 or older, (3) the taxpayer is disabled or (4) the taxpayer has died. Therefore, taxpayers who plan on taking distributions from their traditional IRAs within five years should not convert to a Roth IRA as doing so would offer no additional tax benefit.

## Are Roth IRAs subject to the minimum distribution rules?

Another great advantage of the Roth IRA over the traditional IRA is that the Roth IRA is not subject to the minimum distribution rules while the account holder is alive. When an individual attains age 70 1/2 or retires, whichever occurs later, he/she must begin taking minimum distributions from a traditional IRA and pay income tax on those distributions. These forced withdrawals reduce the amount that can be held in the account on a tax deferred basis and, therefore, reduce the amount that can be passed on to heirs.

An individual who converts to a Roth IRA can allow his/her funds to remain in the account until death. When the account holder dies, the account balance can be paid over the designated beneficiary's life or life expectancy. However, if the designated beneficiary is the surviving spouse, the surviving spouse has the option to roll over the decedent's Roth IRA to another IRA. If there is no designated beneficiary named, the account balance must be distributed by the end of the fifth year following the account holder's death.

## Are there other things to consider prior to converting to a Roth IRA?

Aside from comparing numbers, there are a number of other issues to be consider before converting a traditional IRA to a Roth IRA.

One is the importance of creditor protection to the account holder. Michigan law protects traditional IRAs from the creditors of the account holder, but Roth IRAs will not share that same protection until a technical correction is made to the Michigan statute. Business owners, doctors and others who are subject to increased exposure to lawsuits should strongly consider whether the tax benefits of conversion outweigh the risk of losing their retirement nest egg.

The timing of conversion should also be considered. Account holders who will convert to a Roth IRA in 1998 should consider postponing the conversion until the latter part of the year (as long as they do not wait too long and miss the opportunity to spread the income tax over four years). This will allow account holders to assess the impact of technical corrections to the new law that the IRS is likely to make.

Another factor to consider is future income tax rates. If an individual is currently in a high tax bracket and expects to have a lower marginal tax rate after retirement, it might not make sense to convert and pay income taxes at the higher rate. Foregoing conversion would reduce the tax rate ultimately paid on the funds. Of course, one can only guess at what the income tax rates will be in the future.

One last consideration is the impact of conversion on taxpayers who receive (or who will soon receive) social security benefits. Taxpayers who convert to a Roth IRA in 1998 and who elect to spread the income ratably over four years will increase their taxable income over the four year period and,

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## Discovering Coaching

*On occasion we will make this column available to companies who have products or services that we feel would be of general interest to our readers. Following is an article on "coaching" by Mark Stein, Vice President of PMP, Inc., that we trust you will find useful in your practice.*

Lately, it seems as though being a "coach" is the "in fad" for the more unsettled elements in the business community. Call yourself a coach and hang your shingle. We all know that most of the nouveaux coaches will be gone by this time next year. But, before you write-off coaching as just another fad, think about how your ability to support and add value to your client would be expanded if each of your clients came to their meetings with you knowing that whatever you said would be perfect for them. This is a Coach. More than an advisor; a coach is someone who renews, enriches, and inspires others to greatness.

In personal service industries, giving sound advice or having the latest technology is only the tip of the iceberg for creating real value for your clients. Imagine the CPA/Coach who would use his/her expertise to create a "dialogue" with a client/coachee to create, design, and implement new strategies and perspectives that would generate whole new worlds for the client. Investment counselors would support their clients in expanding and creating their targets, both personally and financially. An effective business coach with a particular expertise could apply that area of expertise much more creatively when they share a special bond with their clients.

### VISION/MISSION/GOALS

In order to be a successful coach in business, one must establish a commitment to the client/coachee that goes beyond his/her specific area of expertise. An effective business coach must convey a commitment to the hidden dreams and aspirations of the client. Every champion begins his quest with a vision. An effective coach nurtures, expands, and supports an inspiring vision.

A vision for the future, however, is only a pipe-dream without the next crucial stage in the coaching relationship. Creating the link between one's calling and one's occupation

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therefore, may subject their social security benefits to increased taxation. Accordingly, individuals who might face this problem should consider foregoing the four year spread election or convert after 1998 to limit their increase in income to one year. To offset the increase in income in the year of conversion, converts to the Roth IRA will have potentially lower incomes in future years since they will not be forced to take minimum distributions.

### **How to "run the numbers" to determine if a conversion would be beneficial.**

There are currently computer programs available which compare traditional IRAs to the Roth IRA. Prior to conversion, one should compare the numbers for each alternative prior to making a decision. Our law firm has software to do the conversion analysis and is prepared to assist you and your clients in this regard.

### **Conclusion.**

The Roth IRA is an exciting new opportunity for taxpayers who wish to save money for their retirement and to provide for their heirs. The ability to convert a traditional IRA to a Roth IRA creates a powerful planning tool for taxpayers which must be carefully scrutinized and examined prior to implementation. Financial professionals who become familiar with the Roth IRA will open the door to additional sources of business and will be more capable of helping their clients achieve their financial goals.

For more information regarding this article, please fax your requests to Paul G. Wakefield at (248) 689-8107.

## The Family Owned Business Exclusion: No Substitute For Sophisticated Planning

One of the more highly publicized provisions of the Taxpayer Relief Act of 1997 is a limited exclusion for qualified family-owned business interests (new Internal Revenue Code Section 2033A). The general rule is that a portion of the value of a closely held business interest may qualify for an exclusion from a decedent's estate if certain criteria are met. The exclusion

is essentially the difference between the exemption equivalent and \$1.3 million. The measurable value of the exclusion will decrease with time since it shrinks in proportion to the growth in the exemption equivalent. The value of the exclusion is \$675,000 in 1998 (calculated by determining the difference between \$1.3 million and the exemption equivalent of \$625,000 in 1998). As the exemption equivalent peaks at \$1 million after 2005, the net value of the family business exclusion will be limited to \$300,000.

Those who endeavor to devise a strategy to preserve the family business from the ravages of the Federal Estate Tax understand that successful planning is closely dependent on predictable results. The development of the family-owned business exclusion was the result of lobbying efforts by special interest groups seeking meaningful tax relief. The result is far from the \$1.3 million exemption that many business owners may believe it to be. Unfortunately, the qualification hurdles, the potential for tax recapture and the impact of inflation, make the family-owned business exclusion of little practical value.

### **QUALIFICATIONS**

The family-owned business exclusion is available only if certain qualifications are met. The requirements that must be satisfied to qualify a business for the exclusion are extensive and include the following: (i) the principal place of business must be located in the United States; (ii) the decedent business owner must be a resident or citizen of the United States; (iii) the interest must pass to a qualified heir (as defined by statute); (iv) the decedent or a member of his/her family must have owned and materially participated in the business for at least 5 of the 8 years preceding the decedent's death; and (v) the value of the qualified business interest (plus certain gifts of business interests to family members other than spouses) must exceed 50% of the decedent's adjusted gross estate.

### **RECAPTURE**

The need for predictable results is essential to forecast and plan for a successful business transition. In order to gain the purported benefits of the family-owned business exclusion, the course of operations of the business must be predicted for a decade beyond the decedent's death. The recapture provisions are triggered if: (i) the qualified heir(s) ceases to materially participate in the business within

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10 years of the decedent's death; (ii) the qualified heir disposes of any portion of his or her interest in the family-owned business within said 10 year period; or (iii) the citizenship or United States situs tests are violated within the 10 year period. If any recapture event occurs within five years after the date of the decedent's death, 100% of the reduction in estate tax attributable to the family-owned business exclusion is recaptured. If the recapture event occurs six years or more after the decedent's death, the recapture percentage is reduced by 20% each year. Generally, the recapture tax will not apply if a recapture event occurs ten years after the decedent's death.

### **CONCLUSION**

The owner of a closely held family business must carefully plan to avoid a financial crisis or potential liquidation of the business in the face of the Federal Estate Tax. While providing some relief to the families of business owners, the family-owned business exclusion is by no means an alternative to advanced estate planning. The initial impact of the exclusion will quickly fade in significance as the exemption equivalent increases. When the exclusion amount bottoms out at \$300,000 after the year 2005, the estate tax savings at the highest estate tax rate of 55% will be only \$165,000. Clearly, the introduction of the family-owned business exclusion is no substitute for more traditional planning techniques. Most families will still be best served by chartering a course of business transition planning which includes sophisticated techniques such as irrevocable life insurance trusts, funded buy-sell agreements, gifts of non-voting or minority blocks of stock, family limited partnerships, charitable remainder, and lead trusts, and grantor retained annuity trusts. In summary, when all is said and done about the family-owned business exclusion, more was said than done.

For more information regarding this article, please fax your requests to Thomas J. Mohan at (248) 689-8107.

## **Beyond The Credit Shelter Trust**

Traditional estate planning routinely involves the use of credit shelter trusts to assure

maximum use of the unified credit. One of the tremendous advantages offered through such trusts is that all growth in trust assets over the initial \$625,000 is also protected from the federal estate tax. The limitation of traditional planning, of course, is that the client is initially only allowed to designate \$625,000 of estate assets for this purpose. For many Americans, \$625,000 per person is simply not enough.

Enter the inter-vivos (lifetime) charitable lead trust - one of the most creative and least used strategies for transferring significant assets to family members or other beneficiaries at greatly reduced federal transfer costs. In addition, the charitable lead trust simultaneously generates a substantial charitable gift.

Here's how it works. A donor-taxpayer contributes assets to a trust in which a charitable organization is given an income interest for a stated period of time. At the end of that designated period, the trust assets revert back either to the donor or to another noncharitable beneficiary - such as a family member.

If trust assets ultimately pass to someone other than the donor - say, to the donor's children - the donor has made a taxable gift. The amount of the gift is calculated by subtracting the value of the charity's income interest from the total value of assets gifted to the trust. Only the balance is considered to be a taxable transfer. Therefore, coupling charitable lead trusts with traditional estate planning can create enormous tax savings.

### **An Example**

Let's look at the example of Widow Wilson. She has an estate worth \$5 million, including highly appreciated publicly traded stock valued at \$1 million. Ms. Wilson owns less than 5% of the outstanding voting stock of the corporation. Ms. Wilson expects the stock to continue to increase in value in the near future, which only complicates an already significant federal estate tax problem.

Ms. Wilson wants her two children to inherit this stock someday. She hates to think they might be forced to sell some of it to pay the high transfer costs. Ms. Wilson has long been involved in charity and likes the idea of leaving a legacy of philanthropy to her family in addition to the usual legacy of assets.

is the next step in effective coaching. Defining the purpose of an enterprise in such a way that supports the attainment of a Life's Vision focuses the energy and enthusiasm generated by a purposeful life into a specific Mission.

Establishing and defining the integral components needed to fulfill the Mission is the next critical step a business coach must support the client/coachee with. Creating and giving life to a view of the future for specific areas of commitment gives one a sense of purpose beyond the numbers. Scoreboards for measuring each goal must be established, but these scoreboards are not the goal. The goal each individual works toward is achieving their piece of the Mission. The numbers measure the value produced, they are not the value in and of themselves.

The role of a business coach is to create a dialogue with an organization's leaders that inspires, renews, and readies that leadership team to express their Personal Life Visions, declare the external value being produced, and focus each individual's efforts toward fulfilling the Mission through goals.

When the service professional becomes a business coach, the service they have to offer becomes a support system linked to the overall success of the client/coachee. What the coach has to say is listened to like it is the perfect input needed for success. The client/coachee becomes duty-bound to take the coaching and make it work. With this kind of relationship in place, the input rendered by the personal service provider can be responsible for unprecedented results, well beyond mere advice.

Pioneering Management Possibilities, Inc. ("PMP"), provides support toward establishing coaching relationships in two ways. First, we coach business leaders to establish a clear and usable Vision, Mission, and Goals for their enterprise. Second, we train others to become effective coaches. We work with service providers to expand their role with their clients and become coaches as well as experts in their field. Our Mission at PMP is to transform businesses into communities of the future that achieve their business goals through satisfied and fulfilled lives.

To discuss and expand your view of coaching in business, please contact Denise Demers, PMP's Director of Marketing and Sales. Denise can be reached at (248) 647-9290 or e-mail at DGDPMPOSS@AOL.COM.

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Therefore, she creates a charitable lead annuity trust ("CLAT") and funds it with the \$1 million of stock. Ms. Wilson elects a 10 percent payout to her favorite public charity from the CLAT for a term of 15 years. The payout consists of the dividends and the sale of shares as necessary. This provides \$100,000 of annual gifts to the charity (10 percent of \$1 million) for 15 years. The present value of the charity's \$1.5 million annuity interest is \$923,325. Therefore, the value of the taxable transfer to her children, ages 47 and 45, is only \$76,675 (\$1 million - \$923,325). This ultimately saves over \$396,000 in federal gift taxes. However, no income tax charitable deduction is permitted as a non-grantor lead trust was used to obtain the gift tax savings. That's phase one.

Let's see what happens when the stock is received by the Wilson children 15 years later. Assume the original \$1 million of stock is now worth \$2 million. The value of the gift is frozen at the original level of \$76,675. This creates an additional tax savings of \$550,000 (\$1 million of appreciation x 55%). The only

downside is that the Wilson children will have the same basis in the stock that Ms. Wilson had.

Ms. Wilson has greatly magnified her unified credit by combining a charitable lead annuity trust with traditional estate planning techniques. She's passed a \$1 million asset (and all appreciation) to her heirs at a greatly reduced transfer rate. In addition, she can shelter the balance of her exemption, after subtracting the \$76,675 gift, inside her credit shelter trust.

Timing couldn't be better to implement this idea because the deduction factor for lead trusts is largely affected by the applicable federal discount ("AFR") rate. Due to current

favorable low interest rates, clients can presently maximize their tax savings. While the same results can also be accomplished through the use of a *testamentary* CLAT, there are two drawbacks to this technique. First, the AFR at the time of death is unpredictable. Second, the donor loses the benefit of seeing his/her wealth benefit others.

In addition to creating powerful tax leverage, the CLAT also provides the opportunity for financially successful individuals to incorporate their charitable aspirations into their estate planning goals.

For more information regarding this article, please fax your requests to Salvatore J. LaMendola at (248) 689-8107.

The estate planning division of Cox, Hodgman & Giarmarco is committed to providing its fellow professionals in the life insurance, financial planning and accounting fields with information regarding the most recent estate planning developments. If you have a particular topic that you would like us to cover in our newsletter, or perhaps at one of our upcoming seminars, please call, fax or e-mail Sal LaMendola at [salvatore.lamendola@mci2000.com](mailto:salvatore.lamendola@mci2000.com) and we will try to oblige you. Also, please visit our website at <http://www.disinherit-IRS.com>.

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Troy, Michigan 48084-4160