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Estate Planning for Private Equity Fund Principals

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There has been considerable debate on Capitol Hill this year over the taxation of a Carried Interest in the context of a Private Equity Fund (PEF or the "Fund"). At the same time, there has been public discussion of the role that the private equity industry will have in our economic recovery. In the realm of estate planning, PEF Principals possess unique opportunities to shift the performance of their interest in a PEF to future generations – potentially resulting in very significant estate tax savings. This article will review the basic PEF structure, describe the nature of a Principal's interest in a PEF and identify wealth transfer techniques that should be considered by a Principal.

Private Equity Fund Primer

Generally, those individuals who founded and operate a PEF are referred to as the "Principals" of the Fund. More specifically, Principals are those individuals who ultimately possess an interest in the general partner entity of the PEF. A "Carried Interest" is an allocation of future profits distributed to a Principal (via his or her interest in the general partner entity of the PEF). The Carried Interest is generally satisfied after the following distributions:

- a return of capital contribution to all investors
- a proportionate distribution of aggregate profits equal to the stated investment hurdle rate of the PEF (the "Hurdle Distribution")
- a catch-up allocation to the Carried Interest holders to make up for the Hurdle Distribution

Typically, the PEF Agreement will provide that the profits remaining after these allocations will be distributed 20% to the general partner entity as Carried Interest and the remaining 80% will be divided proportionately among the investors. The cash flow distributions of a PEF are commonly referred to as the "Waterfall Distribution."

A Carried Interest is currently characterized as capital gain for income tax purposes, which by the nature of the long-term investment strategy of a PEF, permits a Principal to recognize his or her Carried Interest allocation as a long-term capital gain (taxed currently at a 15% federal tax rate). From an income tax perspective, the current debate over how to tax a Carried Interest hinges on two competing arguments:

- **Capital Gains Argument:** A Carried Interest is an interest in the future realized profits of the PEF, which is comprised of aggregate realized capital gains. Therefore, the character of that income should be maintained as capital gain.
- **Ordinary Income Argument:** Notwithstanding the capital gains character of the profits generated in a PEF, a Carried Interest received by the Principals has a disproportionate relationship to the capital contributions made by them via the general partner entity (generally a modest 1% to 5% of total capital contributed to the Fund). Since the Principals are benefiting from the capital contributions of other investors, the Carried Interest is compensatory in nature. Accordingly, distributions received by a Principal via his or her Carried Interest should be subject to ordinary income rates.

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Whether the now favorable income tax treatment of a Carried Interest will be curtailed in upcoming legislation is still unclear. Regardless of the outcome of this debate, due to the methodology inherent in valuing a Carried Interest, wealth transfer techniques leveraged upon the performance of a Principal's Carried Interest remain viable and effective estate planning strategies.

Whether the now favorable income tax treatment of a Carried Interest will be curtailed in upcoming legislation is still unclear. Regardless of the outcome of this debate, due to the methodology inherent in valuing a Carried Interest, wealth transfer techniques leveraged upon the performance of a Principal's Carried Interest remain viable and effective estate planning strategies. In addition to the marketability and minority valuation discounts that are generally afforded a Principal's interest in a PEF, the speculative nature of many investment classes, including private equity, as well as the uncertainty surrounding the tax treatment, create further opportunities for discounting when valuing a Principal's Carried Interest for gift tax purposes. This analysis underscores the question: will the fund portfolio produce a return sufficient to exceed the priority rights stipulated in the Waterfall Distribution under the PEF Agreement? Due to the low current value of the Carried Interest and its potential for significant appreciation, the Carried Interest is an optimal asset to shift wealth to future generations at little or no gift tax cost.

Private Equity Fund Structure Basics

In order to fully appreciate the nuances involved in implementing wealth transferring techniques with Carried Interests, it is important that the client and his or her advisors understand the PEF structure. PEFs are generally limited partnerships, which are pass-through entities for U.S. income tax purposes. Accordingly, there is no entity level tax and all tax attributes of the limited partnership flow through and are taxed to the individual partners. As a limited partnership, the PEF will be comprised of limited partners (those who generally have creditor liability only to the extent of their capital contribution) and at least one general partner (who is subject to personal creditor liability for the actions of the Fund). In the PEF context, outside investors, such as institutions and wealthy individuals, will be the limited partners of the Fund. The general partner interest of the PEF is commonly owned by a limited liability company (the "GP LLC") in which the founders of the Fund and other senior individuals are the managing members, and possibly junior equity holders are granted non-managing member interests. Unlike a limited partnership, a limited liability company affords all of its members personal liability protection; therefore, the potential creditor issues associated with a general partner interest are contained within the GP LLC.[1] It is a Principal's ownership interest in the GP LLC that entitles him or her to a portion of the Carried Interest, and thus that interest is the focus of sophisticated wealth transfer planning strategies.

It is common for a PEF to form an additional management limited liability company ("Management LLC") that provides basic operational services to the Fund, such as contracting for office space and paying Fund expenses (such as, operating expenses, employee salaries, bonuses, etc.). The Management LLC has no ownership interest in the Fund, but is generally owned by the same founders and senior individuals who own an interest in the GP LLC. In exchange for its services, the Management LLC enters into a management contract with the Fund, which entitles it to receive a fee equal to a specified percentage of the current net asset value of the underlying fund portfolio (generally ranging from 1.5% to 2%). Due to its relatively predictable value

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and potential assignment of income issues, estate planning transfers generally do not include a Principal's management fee interest.

Wealth Transfer Techniques for Carried Interests

Under current tax law, a person may transfer a total of $3.5 million upon his or her death without incurring a federal estate tax, which is imposed at a rate of 45%. The amount that may pass free of estate taxes is scheduled to be repealed in 2010. However, a "sunset provision" in the applicable legislation reinstates the federal estate tax exemption to $1 million in 2011. The sunset provision adds a strong measure of uncertainty to the future estate tax structure. Recent attempts by Congress to revisit the federal estate tax have been delayed, but continue to be on the Congressional agenda.

For gift giving purposes, each individual has the ability to give away $1 million during his or her lifetime (the "Lifetime Exemption"). In addition to the Lifetime Exemption, an individual can currently make gifts of up to $13,000 per person per year without incurring any gift tax. This annual gift tax exclusion is indexed for inflation. Thus, at present a married couple can make annual gifts totaling $26,000 to each of their children or trusts for the benefit of their children, free of gift tax and without using any of the couple's respective Lifetime Exemption.

Each individual is also entitled to a $3.5 million exemption against the generation-skipping transfer (GST) tax, which can be used during his or her lifetime (although a gift tax would be due if the transfer exceeded $1 million), at his or her death, or a combination thereof. A GST tax would result on certain transfers to grandchildren and future generations. The GST tax exemption amount will continue to increase in step with the estate tax exemption until 2011.

Lifetime gifting, or wealth transferring, focuses on the efficient use of an individual's Lifetime Exemption to ensure that the assets ultimately subject to estate tax at death are minimized. To optimize the use of the Lifetime Exemption, an individual should focus on transferring assets that have significant potential for appreciation, such as a Carried Interest.[2]

Gift to Irrevocable Trust

The simplest method for transferring a Principal's Carried Interest is to give his or her interest in the GP LLC to an irrevocable trust for the benefit of his or her children and further descendants for no consideration. To optimize the estate tax savings, the trust should include certain administrative provisions to cause the creator of the trust, the "Donor," to be treated as the owner of the trust for federal and state income tax purposes (commonly referred to as a "grantor trust" or "intentionally defective irrevocable trust"). Such provisions should not, however, cause the Donor to be treated as the owner of the trust for wealth transfer tax purposes. Under this structure, all income taxes generated by the gifted Carried Interest will continue to be payable by the Donor without these tax payments being deemed additional gifts to the trust by the Donor. As a result, the Carried Interest and its performance is permitted to grow outside the Donor's taxable estate unfettered by income taxes, while the Donor's payment of income tax on these items further reduces his or her taxable estate for estate tax purposes.

If the Note is fully paid during the Principal's lifetime, the Carried Interest, along with all post-sale appreciation, remains in trust for the Principal's children (and/or grandchildren) free of any transfer taxes.

Sale to an Intentionally Defective Irrevocable Trust

Another wealth transfer option that a Principal should consider is the sale of all or a portion of his or her Carried Interest to an Intentionally Defective Irrevocable Trust (IDIT). An IDIT is another name for a grantor trust, which, as described above, includes certain administrative provisions to cause the Donor to be treated as the owner of the trust for federal and state income tax purposes, but not for transfer tax purposes.

In the PEF context, the Principal would sell all or a portion of his Carried Interest to an IDIT created by him in exchange for a promissory note ("Note") from the IDIT in an arm's length transaction. A sale of the Carried Interest to the IDIT should not be recognized as a sale for income tax purposes (that is, there is no taxable gain) because the Principal (as the Donor) and the IDIT (which is structured as a grantor trust), are treated as the same entity. However, the transaction is effective for transfer tax purposes and, assuming the sale is made for true fair market value, the value of the Carried Interest sold to the Trust IDIT will not be includible in the Principal's estate at his or her death. To ensure that the sale reflects the true fair market value of the Carried Interest, it is imperative that a qualified appraiser be retained to provide a comprehensive valuation report.

The Note may be structured with interest-only payments during the term and a balloon payment at maturity. The interest rate of the Note is based on the applicable federal rate in effect on the date of sale and is paid either from the income earned by the IDIT or trust principal. An "estate freeze" is created by exchanging an appreciating asset (the

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Carried Interest) for a non-appreciating asset (the Note) that earns modest interest. Since the IDIT is structured as a grantor trust, no income needs to be recognized as interest payments are made to the Principal.

If the Principal does not have an existing and funded IDIT to engage in the sale transaction, a new trust will need to be created. The Principal will need to contribute cash, cash equivalents or some of the Carried Interest to the trust to serve as "seed money." The amount of this gift should be at least 10% of the value of the trust assets following the sale, which will help establish the IDIT as a viable, separate entity capable of repaying the Note. The gift may be sheltered from gift tax by using the Principal's Lifetime Exemption (and possibly the Lifetime Exemption of the Principal's spouse) and, if applicable, GST tax exemption. Any additional loans made by the Principal to the IDIT to facilitate capital commitments may disrupt the IDIT's debt-to-equity ratio, which could, from an IRS perspective, affect its economic viability as a legitimate participant in the sale transaction. Thus, the Principal should either consider increasing the gift to facilitate future debts or incorporating an upper-tier Family Limited Partnership or Family Limited Liability Company for this purpose, as described in more detail below.

If the Note is fully paid during the Principal's lifetime, the Carried Interest, along with all post-sale appreciation, remains in trust for the Principal's children (and/or grandchildren) free of any transfer taxes. If the Principal does not survive the term of the Note, the remaining note balance is includible in his or her estate for estate tax purposes.

Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust funded with a single contribution of assets. The terms of the GRAT require annuity payments to the creator of the trust, the "Grantor," over a term of years equal to the full value of the assets contributed, plus interest at an IRS determined rate (commonly referred to as a "Zeroed-out GRAT"). Since the Grantor is entitled to receive back the full value of what was contributed to the trust, plus the IRS assumed rate of return, the use of a Zeroed-out GRAT results in the Grantor using a nominal amount of his or her Lifetime Exemption. The required annuity payments may be made in cash or in kind. Any assets remaining at the end of the annuity term are distributed to the Grantor's children or a trust for their benefit.

The objective of a GRAT is to shift future appreciation on the assets contributed to the GRAT to others at a minimal gift tax cost. For this strategy to be successful the Grantor must survive the trust term and the assets transferred to the GRAT must appreciate at a rate greater than the IRS assumed rate of return. The difference between the actual rate of return on the investment and the IRS assumed rate of return will pass, gift tax free, to the beneficiaries at the end of the GRAT term. If the Grantor dies before the expiration of the GRAT term, the trust assets will be includible in the Grantor's estate, and the advantages of the GRAT strategy will be lost. This risk typically favors use of a relatively short annuity period. However, as described below, a short-term strategy may not be as effective when using a Carried Interest to fund a GRAT.

If there is adverse investment performance and the rate of return on the assets in the GRAT is lower than the IRS hurdle rate, the Grantor will receive back all of the assets contributed to the GRAT via the annuity payments, and nothing will be left for the benefit of the remainder beneficiaries. However, the Grantor will not have wasted an appreciable amount of his or her Lifetime Exemption. Comparing the potential upside versus the minimal gift tax exposure highlights a key tax benefit of the GRAT – when it works, the results are excellent, and when it does not work, the loss is negligible. Based on this characteristic, a GRAT is traditionally viewed as an excellent vehicle to hold a highly speculative investment, such as a Carried Interest, that has the potential for significant appreciation. However, it is important to note that a GRAT is not generally viewed as an appropriate technique to engage in generation-skipping transfers.

The inherent nature of a PEF Carried Interest can present unique obstacles for a GRAT funded only with a Carried Interest. First, a PEF Carried Interest generally lacks cash flow for a considerable period of time. As a result, a short-term GRAT annuity period, which requires greater annuity amounts each year, will require the GRAT to satisfy its annuity obligation to the Grantor with distributions of Carried Interest. To do so, an updated appraisal of the Carried Interest will need to be obtained each year to determine how much of the initially contributed Carried Interest needs to be returned to the Grantor to satisfy the annuity obligation. This can be an expensive exercise and will ultimately affect the performance of the GRAT. Therefore, despite the estate tax risk of the Grantor not surviving the GRAT annuity term, it may be advisable to use a longer term GRAT and contribute some cash to the GRAT in addition to the Carried Interest.

Second, as part of the PEF investment, each investor will be required to subscribe for a particular capital commitment, which is typically called as needed by the Fund. Accordingly, the GRAT, as the owner of the Carried Interest, will be subject to this commitment and will be expected to provide its capital contribution when notified. This requirement can create an additional liquidity problem for the GRAT. Since a GRAT may only receive a single contribution of assets during its existence, consideration should given to including some cash, as part of the initial contribution to the GRAT, for the purpose of satisfying these capital commitments. Of course, the inclusion of too much cash in the GRAT, which by its nature is a low appreciating asset class, may affect the GRAT's overall performance. Alternatively, if possible, the PEF structure could include a separate entity (commonly referred to as a "Side-By-Side Co-Investment Vehicle") to allow the Principal to satisfy the capital commitments, ultimately detaching that obligation from the Carried Interest.

Family Limited Partnerships and Family Limited Liability Companies

It is commonly recommended that the Principal first contribute his or her Carried Interest to a Family Limited Partnership (FLP) or Family Limited Liability Company (FLLC) and then gift the limited partner interest or non-managing member interest, as the case may be, to a GRAT or IDIT, or sell it to an IDIT. This tiered structure is recommended for several reasons. First, since the transfer of the Carried Interest includes the Principal's ownership interest in the GP LLC and thus management rights, the use of an FLP or FLLC to own the GP LLC interest prevents those management rights from being disbursed among various trust entities or individuals. Second, as the owner of the Carried Interest, the FLP or FLLC will receive any cash distributions made by the PEF with regard to the Carried Interest.

Unlike the outright gift of a Fund ownership interest, the CSO technique does not require the actual transfer of the Carried Interest.

Accordingly, the general partner of the FLP or managing member of the FLLC will determine if and when those cash flows are distributed to its limited partners or non-managing members. The possibility of "bottle-necking" cash flows at the FLP or FLLC level may subject the Carried Interest to a second tier of valuation discounts for gift tax purposes. Finally, as a way to finance future capital calls under the Principal's subscription agreement, the Principal would make personal loans to the FLP or FLLC and the FLP or FLLC can pledge its interest in the GP LLC as security for these loans. By including an upper-tier FLP or FLLC in the transfer, the potential pitfalls that may arise with loaning money to a GRAT or an IDIT engaged in a sale are diminished.

Cash-Settled Option

Another planning technique to consider for transferring the economic performance of a Principal's Carried Interest is the sale of a Cash-Settled Option (CSO) to a grantor trust for the benefit of the Principal's children and/or grandchildren. Unlike the outright gift of a Fund ownership interest, the CSO technique does not require the actual transfer of the Carried Interest. Accordingly, concerns about vesting and control, as described herein, are not issues that need to be resolved to implement this strategy.

The CSO strategy consists of the creation and subsequent sale to an IDIT of a CSO with respect to some or all of the economic performance generated by a Principal's Carried Interest. The CSO strike price is generally set at the current value of the Fund interest (as determined by a third-party appraisal), plus any capital contributions made over time with respect to the Carried Interest. The CSO is a modified "European-style" option: exercisable upon the earlier of the expiration date or the Principal's death. In order to determine the value of the CSO, a professional appraiser will need to calculate the current fair market value of the Carried Interest, and thereafter determine the option premium, taking into account the strike price, the volatility of the performance of the Fund interest, current interest rates and the term of the option contract. The IDIT will purchase the CSO from the Principal for the option premium. The funding for the payment of the option premium is provided by the Principal as a gift or loan to the trust purchasing the option, or by using the existing assets of the acquiring trust.

When the trust exercises the CSO, the Principal will be required to pay the trust an amount of cash equal to the value of the Fund ownership interest at such time (as determined by a third-party appraiser), plus all prior distributions received on account of the Fund ownership interest, less the amount of the strike price. If the value of the Fund interest and prior distributions are worth less than the strike price (that is, the Fund is not successful), the CSO will expire unexercised and the Principal retains the option premium paid by the acquiring trust. If no strike price is required by the contract, the trust would exercise its CSO recovering its option premium and any performance in excess of the premium would inure to the acquiring trust.

If the Principal dies before the term of the CSO expires, the CSO is deemed to be exercised by the trust if doing so would yield a profit to the trust. The amount due under the CSO contract would be a liability of the Principal's estate that should be deductible for estate tax purposes. Thus, the pre-death distributions and appreciation are transferred to the trust.

Related Tax Issues

Section 2701 of the Internal Revenue Code

Section 2701 of the Internal Revenue Code is focused on the valuation of a gift to descendants of the transferor[3] of a "junior" subordinated interest, while retaining a "senior" preferred interest, in an entity in which the transferor (or his family members) has "control" over the entity. If Section 2701 were to apply, the value of the gift would be equal to the transferor's entire interest in the entity, which is the aggregate value of all interests owned by the transferor at the time of the transfer – an extremely harsh gift tax result for the transferor. An exception to the application of Section 2701 is commonly referred to as the "Vertical Slice" approach. To fall within this exception, the transferor must include in the transfer a proportionate amount of each equity class in the entity held by the transferor (and applicable family members) immediately preceding the transfer.

If the Principal dies before the term of the CSO expires, the CSO is deemed to be exercised by the trust if doing so would yield a profit to the trust.

As described above, the Waterfall Distribution, by its ordering, will make the allocation of the Carried Interest junior to the return of capital and hurdle rate owed to the limited partner investors, as well as the catch-up distribution to the equity owners of the GP LLC. Central to this analysis is whether the Principal has "control" of the PEF. In the context of a limited partnership, Section 2701 assumes that a Principal (or any member(s) of the Principal's family) holding an interest as a general partner would constitute control for the purpose of applying the statute. In the traditional PEF structure, a Principal will have an interest *in* an entity that owns the general partner interest of the Fund (that is, the GP LLC). Therefore, assuming the Principal (and the Principal's family) does not possess an interest of 50% or more in the GP LLC, arguably control should not occur. However, the only authority to support this conclusion is a Private Letter Ruling 9639054, which does not directly address a Carried Interest transfer and is only binding on the particular facts included in the submitting taxpayer's request.

Moreover, if a Principal would like to proceed with a transfer of something less than a Vertical Slice of his or her equity interests, he or she should understand the potential gift tax consequences associated with this transfer under Code Section 2701. In addition, if the Vertical Slice approach is not employed, consideration should also be given to the potential assignment of income issues that could result.

Vesting

Revenue Ruling 98-21, which addressed the gifting of non-statutory stock options, concluded that the gratuitous transfer to a family member of a non-statutory stock option is not a completed gift for gift tax purposes until the later of (1) the transfer, or (2) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor. Under the traditional PEF structure, the Principal's interest in the GP LLC will vest in accordance with a schedule stipulated in the GP LLC Operating Agreement. Therefore, the IRS could argue that the Principal's transfer of his unvested Carried Interest does not constitute a completed gift until that portion of the interest is fully vested.

To refute this argument, a distinction must be drawn between non-statutory stock options and Carried Interests. Unlike the decision reached in Revenue Ruling 98-21, which focused on the unenforceable rights associated with unvested non-statutory stock options, the interest in the GP LLC immediately confers legal rights to its owner (the Principal and/or any trust or other entity that receives the interest as the result of a transfer), including the right to receive current distributions from the GP LLC. Therefore, those rights are immediately "vested," although subject to diminution should the Principal withdraw from the GP LLC. However, in the case of the withdrawal of a Principal from the GP LLC, he or she may be required to return to the GP LLC any distributions he or she received from the unvested portion of his or her interest.

Other than the enforceable rights argument above, there may be other ways to minimize the potential incomplete gift result. For instance, one alternative is to have the Principal transfer only his or her vested interest in the GP LLC. Another possible solution is to have the GP LLC Operating Agreement require that a withdrawing Principal must reimburse the GP LLC for any prior distributions allocable to his or her unvested interests from the Principal's right to receive future distributions on his or her vested interests.

Conclusion

The use of Carried Interests for lifetime gifting can produce extraordinarily successful results in shifting wealth to future generations. The availability of valuation discounts, including the looming potential income tax changes and financial challenges in the private equity market, make these assets prime for transfer. In order to engage in wealth transfer techniques with Carried Interests, the Principal and his or her advisors must have a significant understanding of the Fund structure and tax issues associated with each transfer technique. The resources devoted to this planning may yield large rewards for the Principal and his or her family.

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[1] If a PEF has significant foreign investors, certain foreign jurisdictions do not recognize limited liability companies as pass-through entities for income tax purposes, but will instead tax them as corporations, subjecting them to an entity level tax. Accordingly, a fund may need to implement a two-tiered general partner that consists of an intermediary general partner limited partnership and second layer general partner limited liability company. It is for this reason, in addition to tradition, that limited partnerships remain the entity of choice in the private equity fund structure. Further, the structure outlined in this article has been simplified for purposes of illustration; it can vary significantly with respect to management fee allocations and other considerations.

[2] For purposes of the *Wealth Transfer Techniques for Carried Interests* section of this article and unless stated otherwise, references to "Carried Interest" means the Principal's ownership interest in the GP LLC.

[3] Descendants include, for example, children, grandchildren, spouses of such individuals and trusts for the benefit of such individuals.

2010 Presents a Potential Planning Opportunity Through Roth IRA Conversions

Shane A. Hart

Beginning in 2010, a planning opportunity becomes available for all individuals owning traditional IRAs. The Tax Increase Prevention and Reconciliation Act of 2005, which was signed into law on May 17, 2006, eliminates the income limitation applicable to converting a traditional IRA into a Roth IRA. Roth IRAs have been around for more than a decade, but due to various income limitations, they have not been available to the affluent. By eliminating the income limitation applicable to conversions of a traditional IRA into a Roth IRA, the Roth IRA will become more widely available.

In 2009 and prior years, an individual with adjusted gross income (with certain modifications) of $100,000 or less could convert a traditional IRA into a Roth IRA. As to contributions to a Roth IRA, the income limitations are a little more generous. In 2009, the following rules apply:

- a **married individual, who files jointly**, may not contribute to a Roth IRA if his or her adjusted gross income (with certain modifications) exceeds $176,000, and may only contribute the maximum amount if his or her adjusted gross income is $166,000 or less
- an **unmarried individual** may not contribute to a Roth IRA if his or her adjusted gross income (with certain modifications) exceeds $120,000, and may only contribute the maximum amount if his or her adjusted gross income is $105,000 or less
- the **maximum contribution** to a Roth IRA is $5,000 (or $6,000 for individuals age 50 and over.

By eliminating the income limitation on converting traditional IRAs into Roth IRAs, Congress has effectively allowed individuals to circumvent the income limitations applicable to making contributions to a Roth IRA. In other words, an individual could simply make a contribution to a traditional IRA and then convert it into a Roth IRA, regardless of income. It is unknown if Congress will seek to address this loophole.

Benefits of a Roth IRA

A Roth IRA can provide numerous planning benefits. In general, assets contained in a Roth IRA and distributions from a Roth IRA are not subject to income tax. Also, there are no required minimum distributions when an individual reaches age 70-1/2, as is the case with other retirement accounts, such as traditional IRAs. These two features of a Roth IRA allow an individual to create a pool of assets that will never be subject to income tax, and that could potentially continue for decades depending upon the designated beneficiaries named under the Roth IRA.

The price that must be paid for this tax-free growth is current income taxation on the taxable portion of the traditional IRA in the year of conversion into a Roth IRA.

Example

If the husband owns a Roth IRA, then he would not be required to take distributions from it during his lifetime. If the husband named his wife as sole beneficiary of that Roth IRA, then at the husband's death, the wife could roll it over to create her own Roth IRA and she would not be required to take distributions from it during her lifetime. The wife could name a grandchild as the designated beneficiary of the Roth IRA, which means the grandchild must begin taking required distributions after the death of the wife. Depending upon the ages of the husband and wife, the Roth IRA assets could grow untouched for decades, and when the grandchild is required to take distributions after the death of the wife, those distributions could be spread over the grandchild's life expectancy.

It may be helpful to apply some real numbers to this example to fully appreciate the planning opportunity. Assume that the husband is 50 years old when he converts a $100,000 traditional IRA into a Roth IRA. If the securities held in that Roth IRA appreciate at a 7.5% annual rate, and the husband dies at age 70, then the Roth IRA would have a balance of approximately $425,000 at that point, assuming the husband does not take any distributions from it during his lifetime. If the wife then rolls it over to create her own Roth IRA, and she lives another 10 years without taking distributions from it, then the balance would be approximately $875,000 at her death. If a 40-year-old grandchild is named as the sole beneficiary of the Roth IRA, then he or she would be able to take distributions over his or her life expectancy, which is nearly 44 years under the applicable tables. If the grandchild took the minimum required distributions over the next 10 years, then the balance would grow to more than $1.4 million, and the grandchild would have received tax-free distributions totaling more than $280,000 over those 10 years. Keep in mind that these results stem from a $100,000 Roth IRA established 40 years earlier, and the grandchild still has many more years of tax-free compounding.

The price that must be paid for this tax-free growth is current income taxation on the taxable portion of the traditional IRA in the year of conversion into a Roth IRA. A traditional IRA may consist of deductible and/or nondeductible contributions, depending upon whether the contributor (or his or her spouse) was an active participant in an employer-sponsored retirement plan, and depending upon his or her adjusted gross income. To the extent a traditional IRA was funded with nondeductible contributions, there would be no taxation upon the conversion into a Roth IRA. To the extent a traditional IRA was funded with deductible contributions (and to the extent of the growth on all contributions), there would be taxation upon the conversion into a Roth IRA.

Example

Assume that an individual had a traditional IRA valued at $50,000 that was funded solely with deductible contributions, and he or she also had a traditional IRA valued at $20,000 that was funded with $12,000 of nondeductible contributions. If that individual converted both traditional IRAs into Roth IRAs, then he or she would have $58,000 ($70,000 minus $12,000) of ordinary income subject to tax. It should be noted that this individual could not simply convert the traditional IRA that contains nondeductible contributions into a Roth IRA in order to minimize his or her income tax liability. In other words, "cherry picking" is not allowed, and all traditional IRAs must be aggregated for purposes of determining the taxability of a conversion. The individual could, however, minimize his or her income tax liability by converting one-half of his or her traditional IRAs, which would result in $29,000 ($35,000 minus $6,000) of ordinary income subject to tax.

Conversion Is Not for Everyone

Conversion of a traditional IRA into a Roth IRA is not for everyone. Many individuals may prefer to defer income taxes, rather than trigger current income tax liability with a conversion. A conversion is most advantageous under one or more of the following circumstances: (1) an individual expects to be in a higher income tax bracket during retirement when he or she plans to take distributions from the Roth IRA; (2) an individual has a traditional IRA that was funded with a significant amount of nondeductible contributions, so the income tax impact of a conversion is minimized; (3) an individual will not need the Roth IRA assets to fund retirement, but would prefer to use it as a vehicle to benefit heirs; and (4) an individual has sufficient assets

From an estate planning perspective, it is important to keep in mind that taxable retirement accounts (like traditional IRAs) are not the best assets to leave to heirs, because they are potentially subject to both the estate tax and the income tax when distributions are made to heirs.

outside of his or her traditional IRA with which to pay the income tax triggered by the conversion.

Reasons to Convert

Under the Tax Increase Prevention Act of 2007, Congress provided an extra incentive for individuals to convert their traditional IRAs into Roth IRAs in 2010 by allowing the amount of income from a 2010 conversion to be spread ratably over 2011 and 2012. This tax deferral is available for 2010 conversions only. Clearly, Congress views conversions into Roth IRAs as a revenue raiser, and wants to encourage taxpayers to join in.

From an estate planning perspective, it is important to keep in mind that taxable retirement accounts (like traditional IRAs) are not the best assets to leave to heirs, because they are potentially subject to both the estate tax and the income tax when distributions are made to heirs. The income tax hit to heirs may be alleviated somewhat by a deduction under Section 691(c) of the Internal Revenue Code, but this deduction is not always complete. By leaving a Roth IRA to heirs, however, an individual avoids the potential income tax liability.

In deciding whether or not to convert a traditional IRA into a Roth IRA, it is difficult to predict where income tax rates will be in the future, but many advisors view a Roth IRA as a hedge against a potential spike in income tax rates. Also, many advisors suggest "tax diversification," which means you own assets that are subject to different forms of taxation. For example, you maintain some tax-free assets (like assets held in a Roth IRA), some assets subject to ordinary income tax rates (like assets held in a 401(k) or traditional IRA), and some assets subject to capital gains rates (like stocks held in a brokerage account). This way, during retirement, you have options depending upon the income tax regime in place.

In conclusion, the conversion of all or part of an individual's traditional IRA into a Roth IRA is a planning opportunity that should be explored now that the income limitation will be eliminated in 2010 and beyond.

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Technological Advances Create New Obstacles for Personal Representatives

Sarah S. Butters

Due to technological advances, many people now receive and pay nearly all of their bills online. While paperless billing is efficient and eco-friendly, it can unduly complicate the administration of an estate. Online bill payments often leave no paper trail behind to assist a deceased person's family or executor in identifying their assets or liabilities. For obvious security reasons, many individuals do not keep a list of their online accounts, pass codes, or even access information to their email addresses where statements are often received. As a result, the task of locating assets and liabilities becomes even more complex and time consuming for the loved ones who are left behind.

It is important to provide someone with access to your online information, including security accounts, bank accounts, credit card statements and email accounts.

Online Accounts – Hard to Research

Nearly every state's probate code requires that some effort be made by an executor to identify the creditors of a decedent and satisfy his or her just debts. Accordingly, it is important to provide someone with access to your online information, including security accounts, bank accounts, credit card statements and email accounts. In addition, it is important to note deposits that are automatically made to your accounts and bills that are automatically debited from your accounts each month. If no one else has this information, how will your executor identify your creditors and verify the amount due to them after your death?

Typically, a probate attorney will advise an executor to collect several months worth of a deceased person's mail to determine what bills might be due in a typical monthly billing cycle. This task would prove fruitless, however, if the decedent subscribed to paperless billing. Similarly, probate attorneys often advise an executor to go through the decedent's checkbook in an effort to identify the decedent's creditors. Today, however, those techniques would likely provide little information because nearly every financial institution not only provides, but encourages, online bill paying, rendering a checkbook nearly obsolete.

Paperless Transactions – Another New Challenge

To further complicate matters, many people have opted out of receiving hard copies of statements for securities and bank accounts, and instead do all of their banking online or receive electronic monthly account statements. As a result, family members are often left without any access to information regarding a decedent's assets and liabilities. To assist your loved ones and executor in identifying your assets and liabilities, it is a good idea to keep a current list of all online account information, including the following:

- bank and brokerage accounts: detail their web addresses, your log-in and pass code
- email accounts: list all personal email addresses where you might be receiving monthly statements or other financial information
- creditor information, including any bills automatically debited from your account and/or those that you customarily pay online through an online bill pay program
- any creditors that are paid via direct billing to a credit card; for example, utilities, newspaper subscriptions, commuter passes, etc.

What you do with this list, however, may be a difficult decision. For security reasons, you may not want a written document with all your security information lying around in your home or office. Additionally, many people do not want to provide even their most trusted loved ones with a written list of critical passwords and access information until it becomes absolutely necessary.

Virtual Safe Deposit Boxes – An Online Option

In an effort to provide some solution to this growing problem, a number of online companies now offer a way to manage online information in the form of a "virtual safe deposit box." For a fee, companies like iGoodbye.com and LegacyLocker.com will hold in escrow all of your login names, passwords and other electronic data until the person you have designated retrieves this information in accordance with the terms you have established. Typically, this would require that the designated person produce his or her own driver's license along with sufficient evidence of your death, before any stored information is released.

To assist your loved ones and executor in identifying your assets and liabilities, it is a good idea to keep a current list of all online account information.

Similar companies like safedepositbox.com, FireDrive Inc. and E-Safe also provide secure, online storage of documents and information. For example, an individual can store digital copies of documents related to their assets, investments, prior year tax returns and insurance policies. Other helpful information that can be uploaded for storage (in case the originals of these documents are lost, destroyed or could not otherwise be located after death), might include copies of life insurance beneficiary designation forms, a last will and testament, deeds and mortgages.

Prices for these services range anywhere from $9.99 to as much as $80 per year. Some companies even offer a one-time, lifetime fee, at a cost of about $300. While some may feel these costs are high, often they are only a fraction of the cost that might be spent trying to piece this information together after one's death. As these types of services become more commonplace and time-tested, it will become easier to separate those that can be expected to be around for the long term from unsuccessful start-up operations. And, as is the case with other estate planning tools, leaving your affairs in an organized manner allows your loved ones to mourn without the added stress of trying to identify what assets you have and what bills need to be paid.

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