Norman J. Politziner's
Financial Planning

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Retirement Income Alert: Do You Own A $1 Million Plus IRA In A High Income-Tax State?

If you own a $1 million IRA account and live in a state with a high income-tax rate, here's a financial planning tip that could save you thousands annually on state income tax. The strategy requires setting up a trust in a state with no income tax, which is probably not something you do every day. So, here's a primer.

This is a new way to legally reduce your taxes and comply with current tax law, and a key principle driving the strategy recently was affirmed by a Supreme Court ruling. Basically, the non-grantor trust you would set up creates a new taxpayer in a state with no income tax. Then, the non-grantor trust distributes income. If you live in a state with an income tax, establishing the trust outside the reach of the state in which you live eliminates the state income tax you'd otherwise owe.

A recent U.S. Supreme Court ruling upheld the key principle behind the strategy. The June 21st, 2019 majority opinion of the Court ruled against the state of North Carolina, which had argued that Kimberly Rice Kaestner, the beneficiary of a North Carolina trust, owed the state tax on income she received through the trust. The North Carolina trust had been set up by her father, Joseph Lee Kaestner III, a New York resident, in 1992, with Ms. Kaestner named as one of the beneficiaries. In 1997, Ms. Kaestner moved to North Carolina and many years later the state assessed an income tax on the trust, citing a law authorizing North Carolina to tax any trust income for the benefit of a state resident.

The Court rejected North Carolina's argument, saying it had violated the Fourteenth Amendment's due process clause, since the beneficiaries had no right to demand the income from the trust and are uncertain to receive it. In fact, the trust had paid

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Life Is A Learning Experience

One of the wonderful things about working with so many clients is that there is ample opportunity to learn new things.

If we pay attention, learning from our clients, as well as others, is like getting an advanced degree in business and in life. Sharing life stories and legacies can be one of the most rewarding aspects of my business, i.e., how folks started in their business, or hard times, family stories, grandchildren stories. These bring a smile to my face and a better understanding of life and family dynamics.

So, let me share one with you. My grandson, Ethan, had his Bar Mitzvah a couple of weeks ago. He had asked that I help him with his part in the service. We worked together over the past few months and then the day came.

To my surprise, the Rabbi motioned to Ethan and he began leading the service, something that very few kids are capable of doing. The parts that I had helped him master were the traditional parts of a Bar Mitzvah service and he did a great job. Leading the rest of the service was something he wanted to surprise me with; and boy was I surprised...and proud of him. That day, in the eyes of Judaism, he became a man. He gave me a gift that I will always cherish.

But, I wasn't so happy about him beating me in basketball.

Norm

How To Sell Your Small Business And Pay No Taxes

So, you want to sell your small business? The good folks in Washington have a dandy tax break exempting you from all federal taxes on the sale—provided that you own a C corporation.

A lot of attention has gone to the special "pass-through business" break from the new tax law. This benefits income from S corporations and others like it, giving owners a 20% exemption on their business' earnings. That highly popular provision in the Tax Cuts and Jobs Act makes it seem like small business owners would be idiots to classify their company as a C corp.

Well, except for the terrific advantage you get as a C corp seller, which has been available for many years. Aside from the TCJA exemption and the lack of double taxation, C corps are taxed at the corporate level and then the owners get taxed on what they reap after that. In contrast, pass-throughs, like S corps, LLCs, and other partnerships, are only taxed once. C corp shareholders pay zero tax on a company sale, as long as they acquired the shares on or after Sept. 28, 2010. That's a huge tax break!

The gracious 100% tax exclusion is available to anyone with stock in a C corp for over five years. Taxpayers get a smaller break on shares owned before Sept. 28, 2010. You're also entitled to a 5% exclusion on C corp shares owned from Aug. 9, 1993 to Feb. 17, 2009. C corp shares purchased between Feb. 18, 2009 to Sept. 17, 2010 receive an exclusion on 75% of the gain on the purchase price in the event of a sale. If you owned your C corp shares prior to the Aug. 9, 1993 date, you're out of luck.

To get this tax-favored status, called a Qualified Small Business Corporation, or QSBC, a small company must meet a batch of requirements. The business' gross assets must be less than $50 million, and the exclusion is capped at the greater of $10 million or 10 times the aggregate basis of the stock the taxpayer sold during the tax year.

Say you sell your business for $10 million. If the QSBC break didn't exist, and your capital gains rate is 23.8% (the top rate of 20%, plus a 3.8% surtax for singles making more than $200,000 annual or couples hauling in over $250,000), you'd owe $2.38 million to the IRS. But thanks to the QSBC benefit, you'd owe the government zilch.

And here's a kicker. Both C corps and pass-through businesses are helped by the new, lower federal tax on companies, 21%, down from 35%. ●

Be Prepared For Tax Policy To Swing Back

For business owners, professionals, and wealthy families, tax rules are about as favorable as they've been in decades, but the tax policy pendulum could swing back again. Be prepared to make some important financial decisions much sooner than had been expected.

For example, the lifetime tax exemption for gifts made in 2019 is $11,400,000, up from $11,180, 000 in 2018. It doubled over the $5.43 million in effect in 2017 and is scheduled to ratchet higher through 2025, as a result of the enactment of the Tax Cuts & Jobs Act (TCJA). In 2026, the exemption reverts back to the level in effect before the TCJA became effective in December 2018.

That means families should have many years before they would be forced to decide whether to make gifts in 2025 to maximize their exemptions from tax in passing their wealth to family members. The 2025 peak in the exemption amount forces a decision about whether to give assets to loved ones while you're still alive or hold onto your assets and give them away after you die. In 2025, you use the $12-million-plus exemption or lose it, and the exemption reverts back to a much lower amount in 2026 and beyond.

However, the tax policy pendulum — a politically charged issue — could swing in the other direction in the months ahead. Business owners, professionals, and other high-net worth individuals may need to make decisions about gifting assets much sooner. There is no assurance that you will have until the end of 2025 to make this important strategic decision about passing on your family wealth.

Point is, if tax policy changes, business owners, professionals and individuals benefiting from strategies enabled under the TCJA, may be forced to make decisions about income tax as well as estate and gift tax

The Reality Gap Widens

Stocks have been more volatile because the difference between perception and reality of financial economic conditions is growing wider.

The S&P 500 — the key benchmark of America — is supposed to price shares after discounting everything — the Federal Reserve's policies, politics, inflation, and population trends.

When fundamental facts grow harder to discern, stocks grow more volatile, and that's what's been happening lately, especially with the widespread misperception of the yield curve inversion.

A yield curve inversion is when the yield on 10-year US Treasury Bonds is less than the yield on three-month T Bills.

Since the 1960s, when investors thought the 10-year long term outlook for bonds looked worse than the three-month outlook, inverting the yield, recessions usually followed 12 to 18 months later.

While the recent inversion of the yield curve is perceived as evidence a recession is on the way, the reality is very different.

The inversion of the yield curve currently is being driven by negative interest rates in Europe.

Negative yields in Europe and Japan — an unprecedented condition in the largest economies in the world — is a new thing and it's not widely understood.

Bond yields are set in a global market, and the U.S. and Germany supply globally-traded, highly-liquid, government-guaranteed securities owned by the world's largest financial institutions.

Because yields in Europe have been kept low by European central bankers to stimulate growth — and another round of quantitative easing is planned — it's depressed yields on long-term U.S. Government bonds.

That's a market problem, a "technical" issue of supply and demand of government bonds, and investors will want to consider the effect of lower returns on their bond allocations in the years ahead.

However, this inversion is not a fundamental economic problem!

It won't cause a recession, though it has led to a widespread misperception about current economic conditions.

The underlying cause of negative yields in Europe is its aging labor force which is an important fundamental trend affecting Japan and China as well as Europe.

A nation's economic growth potential is a simple equation, driven by the size of its labor force — the working age population — and its rate of productivity.

The working age population trends in China, Japan, and Europe, the world's largest economies after the U.S., are unfavorable relative to the United States.

GDP growth potential in Europe is limited by its aging working population.

To increase growth in Europe, China and Japan in the face of this demographic headwind would require higher productivity but productivity gains are hard to plan.

The U.S. has favorable long-term demographic prospects compared to the world's major economies.

The baby boom peaked in from 1957 to 1961, and peak retirement for the boomers will occur from 2022 to 2026; then, growth in the working age U.S. population picks up.

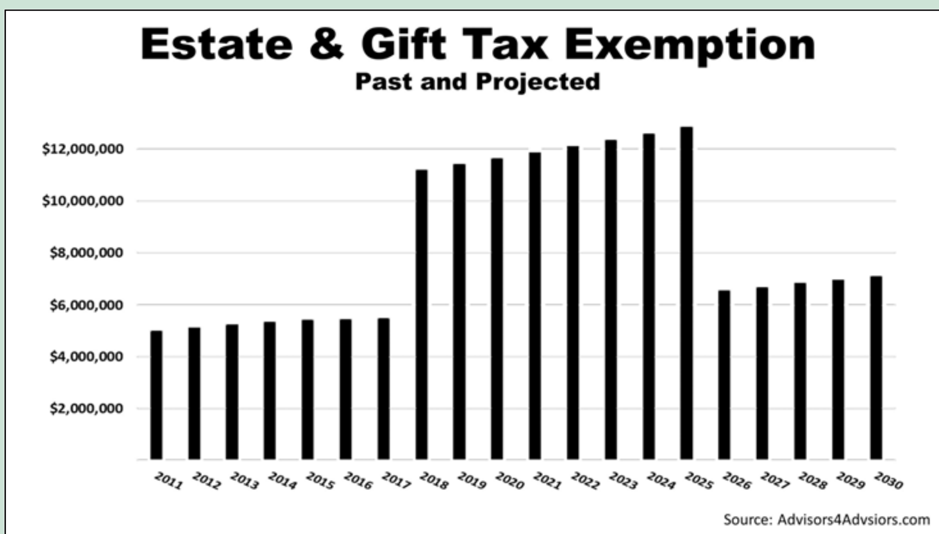
Although you often hear that the next generation of Americans won't have a standard of living comparable to ours, the U.S. demographic trend compared to the other developed economies — Europe, Japan and increasingly China — is very favorable.

The U.S. has a large echo boom population coming — and they don't.

This fundamental driver of economic growth is one reason why the U.S. will likely continue to be a magnet attracting foreign investment capital in the years ahead.

As markets continue to piece together the puzzle driving financial economic reality, expect stock market volatility. ●

strategies much sooner than they might have expected. It's not an issue you want to fall behind on and will require personal and professional tax advice. ●

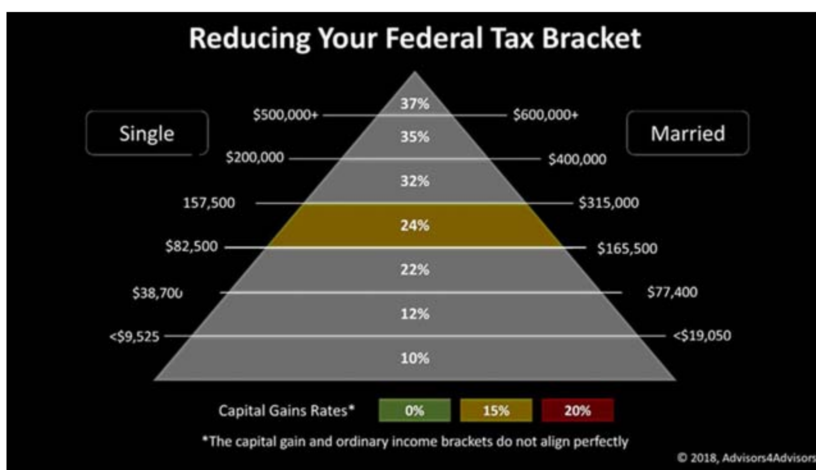


Asset allocation cannot eliminate the risk of fluctuating prices or uncertain returns. Diversification does not assure a profit or guarantee against loss.

High Income Earners & Roth Conversion

Roth IRAs are tax-free, making them popular, but a married couple is ineligible to contribute to a Roth if they earned more than $199,000 of modified adjusted gross income in 2018 ($135,000, if single). A "backdoor" around this limit enables you to convert traditional IRA assets into tax-free Roth IRA accounts, even if you're over the income limit. Here's a strategic approach for maximizing the backdoor route to get tax-free Roth treatment with the least amount of conversion-tax.

When you convert a traditional IRA to a Roth account, you are required to pay tax on the income withdrawn from your traditional IRA. If you do not have the cash on hand to pay the extra income tax you'll owe next April 15, you probably should forget about converting now; withdrawing a larger sum to pay for the income taxes is a risky financial bet and is generally unwise.



If you have the cash on hand to pay the extra income tax you'll owe in the year you draw from your traditional IRA to make the conversion to the Roth, your next move is maximizing your tax bracket. For instance, if your taxable income is $177,500 after making a $100,000 withdrawal from the traditional IRA, consider lowering the amount you convert to avoid pushing you into the 32% bracket. Reducing a $130,000 contribution to a Roth by $30,000 lowers your maximum tax bracket to 24%, for example, giving you the maximum benefit of the 24% bracket.

Because of the stock market's performance in 2018, you may be able to convert a traditional IRA to a Roth with little or no tax taxes. If you funded a deferred compensation plan or traditional IRA with after-tax income in late 2017 or 2018, its fair market value may be lower now than the amount you contributed, and you could convert that traditional IRA account to a Roth tax-free!

To be clear, if you made after-tax contributions to an IRA in 2017 or 2018 and it's shown little or no appreciation, consider converting that IRA to a tax-free Roth IRA, and because you will owe little or no additional income tax on the conversion and — unlike the traditional IRA — the Roth will create tax-free income upon withdrawal.

If you made after-tax IRA contributions to a traditional IRA in 2017 or 2018, or if you want to evaluate a Roth IRA conversion, please contact our office because this is a technical tax topic that requires specialized tax advice. ●

Retirement Income Alert

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no income to the beneficiaries in the years for which North Carolina claimed taxes were owed!

This strategy is particularly timely because of a looming reform to the federal tax law. The tax proposal, which is widely expected to be signed into law by the end of 2019, requires that distributions of income from IRAs you leave to non-spouse beneficiaries — your children and other loved ones — be distributed over 10 years. This would prevent your heirs from taking minimum annual distributions based on their life expectancy on inherited IRAs — a popular strategy known as a "Stretch IRA." By utilizing a trust to move the IRA distributions to a state with no income tax, your beneficiaries avoid state income tax on those required distributions of income on inherited IRAs.

Why does this advisory merit urgent attention of individuals with IRAs exceeding $1 million in high income tax states, even though the proposal may not be signed into law until the end of the year? The answer: Because both chambers of Congress and President Trump have expressed support for the reform.

This aspect of retirement income planning is fraught with complexity. New York and California recently enacted laws adversely affecting non-spouse beneficiaries residing in states with an income tax. Please contact us with questions about this topic, as this strategy requires personal advice from a qualified tax professional. ●

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