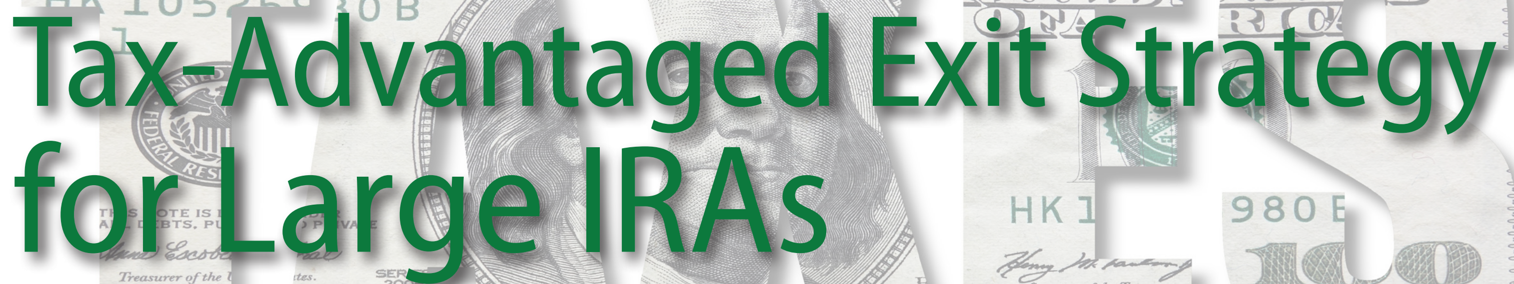

Tax-Advantaged Exit Strategy for Large IRAs

To quote Ed Slott, the Nation's #1 authority on IRAs and IRA tax planning: "IRAs are different. They're tax liabilities unlike any other. An IRA is an IOU to the IRS."

Effective January 1, 2020, SECURE Act became law; followed by SECURE 2.0 on January 1, 2023, among other things, imposing new draconian tax consequences for passing large IRAs to heirs.

Financial planners traditionally recommend the following solutions:

1. Convert IRA to Roth, pay the taxes, then allow the Roth to grow tax-exempt.

2. Live off the IRA as income.

3. Make (tax-free) Qualified Charitable Donations – which remove the IRA from the owner's account and are limited to $100,000 per year after age 70½.

None of these strategies eliminate an IRA on a no-tax-due basis and allow the owner to retain possession of the IRA funds. However, there is a way for the owner of a large IRA to get out from under it entirely lump sum – on a net zero-tax basis and still retain ownership of the money. But it comes with some strong caveats and is NOT for everyone.

Section 26 U.S. Code § 181 of the Internal Revenue Code is a provision for the Treatment of Certain Qualified Film and Television and Live Theatrical Productions. In essence, this provision allows an investor in a qualified film project to declare the entire sum invested as a deductible capital loss starting the year the investment occurred. Traditionally, the value of Section 181 is to offer protection against loss should the film project fail to return the investment but functionally that is only equal to the same percentage of the investor's applicable tax brackets. For example, an investment of $1,000,000 by someone in the 37% top marginal bracket would be protected from $370,000 of total loss.

Having said that:
1. Few films fare so poorly that 100% of the investment is lost.

2. Many films receive financial perks such as state film incentives, product placement dollars, etc. that mitigate potential loss to an investor.

3. Nobody should invest in a film that lacks a Completion Bond which protects investors against loss because the film was never completed.

4. Finally, film investing is well known to be risky and film investors expect to be adequately rewarded for their risk by strong return expectations, the terms of which are clearly defined by contract.

ENTER THE PRETAX QUALIFIED ACCOUNT:
As already noted, anyone with a large Pretax Qualified Account (e.g., IRA 401(k), 403(b), 457, etc. – not Roth) has a formidable future tax liability.

1. With limited exceptions, ANY withdrawal from an IRA is taxable as ordinary income at the applicable marginal tax bracket – including a higher bracket should that withdrawal result in crossing a tax bracket threshold.

2. Starting at a Required Beginning Age (RBA), distributions are mandatory: 70½ prior to January 1, 2020; then 72 effective January 1, 2020; then 73 effective January 1, 2023; and 75 for those who turns 73 on or after 1/1/2033.

3. Those Required Minimum Distributions (RMDs) become progressively larger (based on the Uniform Life Table) each year throughout life.

4. For most people, the schedule of RMDs will NOT result in overall reduction of the IRA until they reach their early to mid-80s. That means the size of the RMDs continually increases, potentially impacting how much Social Security is taxed, potentially increasing the cost of Medicare Part B premium, by as much as 360%.

5. At inheritance, most beneficiaries are subject to a 10-year liquidation mandate – all taxes due – with a lot of complexities in mandatory distribution schedule – and severe penalties for mistakes.

In other words, large IRAs can be an unequivocal tax nightmare.
What Section 181 offers is an avenue for high net-worth investors with large IRAs to escape the tax liability of these accounts on a net tax $0 basis.

There are 3 important caveats:

• The prospective film investor MUST be an Accredited Investor defined as an individual with either: 1) Over $1,000,000 in net assets or 2) Gross income exceeding $200,000 individually or exceeding $300,000 joint income with either a spouse or domestic partner.

• The investor MUST be not younger than 59½, otherwise, a 10% tax penalty will apply to the withdrawal and that penalty will NOT be offset by the 181 deduction.

• The Film Production MUST spend all the investment from IRA in the SAME tax year as the investment. Otherwise, there WILL be a taxable report which cannot be offset dollar-for-dollar by the 181 Deduction – and there is no allowable "retroactive" deduction for last year.

Otherwise:

1. The investor withdraws funds from the IRA. This generates a taxable report (Form 1099R) on the IRA liquidation with taxes due by the tax filing deadline (e.g., April 15) for that tax year.

2. The investor then invests that same sum in the film and reports a tax loss (under Section 181 for the entire sum. The declared loss is a dollar-for-dollar offset of the taxable income from having liquidated IRA funds. The result is a net $0 tax bill. This concept is comparable to offsetting capital gains on investments with capital losses to negate exposure to capital gains taxes on the sale of the appreciated assets.

3. Later, if/when the film returns the investment, those receipts are reported as ordinary taxable income. However, from that point onward, the money is Non-Qualified meaning:
a. There are no RMDs for anyone.
b. The principal (basis) is now not taxed.
c. Gains are taxed at lower Long-term Capital Gains rates.
d. It receives a step-up in basis upon inheritance.
e. Has no mandate for an heir to empty the account.

The potential argument that the tax liability to the investor (as income) is the same as the taxable report from liquidating the IRA misses an important mark. Using this manipulation effectively converts the IRA into non-IRA and even though the funds are ultimately taxable (as income), it spreads the taxes out based on future profitability of the film. As such, while there is a return of the funds as taxable, they now get to enjoy the possibility of future growth as long-term capital gains (for the investor) and then enjoy a step-up in basis (not taxed and no 10-liquidation mandate) for heirs.

Moreover, by not reducing the size of the IRA, means it continues to grow (as an IRA) until the start of RMDs which will also substantially grow, thereby greatly increasing the aggregate tax due. For example, assume a 60-year-old has a $5 Million IRA, growing at 7% per year, that account will have ballooned to nearly $14 Million and have a first year RMD of well over $500,000. If that person lives to age 90, then the IRA is inherited, that initial $5 Million IRA may have generated aggregate tax bills (taxes paid, not distributions reported) of $15-$20 Million! Conversely, if the IRA is eliminated under this plan, the total tax load from RMDs is $0. Even assuming the invested $5 Million returns $10 Million as income, the total tax due (at 37%) on all that income is $3.7 Million!

In other words, based on this scenario, the 181 manipulation would have resulted in a total tax savings of over $11-$16 Million; 2 to 3 times what the initial IRA was even worth.

Final Word:

For this strategy to work, a prospective investor MUST coordinate with a professional film production company that is producing a Section 181-Qualified Film. Despite the advantages highlighted here, film production (and film investing) are very complex endeavors which under no circumstances should be contemplated by anyone who is not very well connected with and/or skilled in the film industry. There are numerous subtle legal requirements that must be adhered to. Of course, there is no moratorium exploring possibilities and asking questions. But anything beyond that, without the full complement of necessary requirements, is very ill-advised.

Note: any prospective investor using this strategy needs to be a resident of a state with no state income tax applied to the liquidation of qualified funds. Otherwise, that investor could be exposed to state income tax that cannot be recovered through the outlined strategy.

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