By **James Lange**

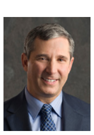
Using Tax-Free Income to Prepare For the Death of the Stretch IRA

I began examining the likelihood and consequences of the impending death of the stretch individual retirement account. "Stretching" an IRA refers to the practice of partially sustaining the tax-deferred status of an IRA when, after the death of the owner, the account is left to non-spouse beneficiaries (typically, children). Unfortunately, the stretch IRA is under siege, and if eliminated, a non-spouse beneficiary of an IRA will be required to pay income taxes on the entire inherited IRA within five years of the IRA owner's death (technically on Dec. 31 of the year five years after death). In my previous article, I made the case for naming a charitable remainder unitrust (CRUT), rather than the children, as the contingent beneficiary (after the spouse) of the IRA. I didn't, however, recommend drafting any new documents or implementing this change until after the new law passes. I also pointed out some of the limitations of the CRUT.

I'll now present two additional promising solutions that your clients can act on before the law changes. Let's move away from the tax-deferred world into the tax-free world by discussing Roth IRA conversions and life insurance.

Roth IRA Conversions

A majority of IRA and financial experts whom I've interviewed on my radio show believe Roth IRA conversions deserve serious consideration in the big-picture analysis of a client's financial strategy.[1] In our office, we don't make any recommendations on Roth conversions until we "run the numbers." The analysis will indicate whether a conversion is advantageous and, if so, how much and when to convert. Some clients want us to stop the analysis as of the death of the husband and wife. Other clients prefer to continue the analysis through the lives of their heirs. Frequently, we find that a series of Roth IRA conversions while the parents are alive provide better results for both the IRA owner and his spouse, as well as their children.



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Unfortunately, the proposed legislation also has the Roth IRA in its sights. Under the proposed law, a Roth IRA left to a non-spouse beneficiary will have to be liquidated within five years of the owner's death. The good news is that, at liquidation, it isn't taxed. The money in the inherited Roth IRA becomes plain old after-tax dollars. The basis for the distributed property or money will be the account's fair market value as of the liquidation date, which presumably, will be five years after the owner's death.

Even if non-spouse beneficiaries are required to liquidate inherited IRAs (of all types) within five years, we'll still be fans of the Roth IRA conversion. If your client begins making a series of Roth IRA conversions now, the converted amounts will grow income tax-free for as long as the money remains in the Roth. That could be for the rest of your client's and his spouse's lives, and, under the proposed rules, for as long as five years after their deaths. And, unlike traditional IRAs, Roth IRAs aren't subject to required minimum distributions (RMDs) while the owner and spouse are living.

A series of Roth conversions can also benefit the second generation. The children will pay less income tax on the inherited IRA distributions because the balance will have been reduced by the amount that was converted. They would also inherit a Roth IRA.

A Roth conversion may also reduce federal estate taxes, or more likely, state inheritance taxes. By making a Roth conversion, you're effectively getting the income tax out of the taxable estate. Let's assume that: (1) your client has a traditional IRA worth $1 million, $280,000 in non-IRA after-tax dollars, and (2) the tax on conversion and the client's tax bracket is 28 percent. If he doesn't make a Roth conversion, the entire value of the IRA and after-tax dollars will be included in his taxable estate. On the other hand, if he converts the $1 million traditional IRA to a Roth IRA and uses the $280,000 after-tax dollars to pay the tax, his taxable estate will only be $1 million. (Let's forget about growth on the account and the ability to convert at 28 percent for the moment). After the $1 million Roth IRA conversion, your client's purchasing power will be

equivalent to what it was with the taxable traditional IRA and after-tax portfolio. That is, if he cashed in his $1 million IRA, he would have to pay the $280,000 in taxes. Accordingly, he would have the same purchasing power. The difference is that after the conversion, the Roth grows tax-free, but the growth in the traditional IRA and the after-tax investments are taxable.

Finally, what if the new law is never passed or your client dies before it's passed? The advantages of a well thought out Roth IRA conversion strategy can still be advantageous to many, if not most, IRA owners and their heirs.

Life Insurance Options

From an income tax perspective, life insurance has more in common with Roth IRAs than many people realize. If your client does a Roth IRA conversion, he must voluntarily pay income tax before he's required to in order to receive a Roth IRA, which then grows tax-free. If your client pays for life insurance premiums by making taxable withdrawals from a traditional IRA, he voluntarily pays income tax before he has to in order to receive an asset that will be tax-free to his beneficiaries—his life insurance.

Though my analysis will concentrate on a second-to-die policy, the same concept could be applied to other types of life insurance. Second-to-die life insurance doesn't pay a benefit until both the husband and wife die, so it tends to be less expensive than insurance on one life.

With the existing law, recommending the combination of stretch IRAs and second-to-die life insurance is like recommending peas and carrots; they just work well together. A frequent recommendation in the estate plans our office prepares (I've done this with my own planning) is to purchase a second-to-die life insurance policy and include disclaimer provisions in the beneficiary designation of the IRA. We usually recommend the spouse as the primary beneficiary of the IRA and the children equally as the first contingent beneficiaries. We then recommend the grandchildren (or trusts for the benefit of grandchildren) for the second contingent beneficiaries. The spouse is given the option to keep or disclaim the IRA to the children. Each child is given the choice to keep or disclaim his portion to his children. If the law doesn't change, after both spouses die, the children would be more likely to disclaim the IRAs because the grandchildren will get a long "stretch," and the children could keep the life insurance. If the law does change, the children would be far less motivated to disclaim the inherited IRA to their children because the grandchildren would have to pay income taxes on it within five years of the IRA owner's death. Regardless of what happens to the law, as I will show, a second-to-die policy can provide tremendous flexibility for your clients' heirs.

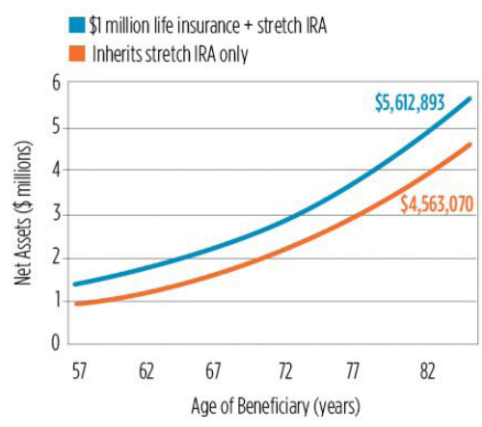
Pension Rescue

Many advisors used to create models for their clients of the amounts that were expected to be left to the children. The scenarios were modeled with and without life insurance. There was a popular strategy called "pension rescue." The idea was that the IRA owner would withdraw a specified percentage of the IRA, even as low as 1 percent or 2 percent, pay the income tax on the withdrawal and use the proceeds to pay for a second-to-die life insurance policy. I liked that approach in general, but I didn't like an important assumption that was part of those presentations, which was that the child beneficiary wouldn't take advantage of the stretch IRA and would simply liquidate the inherited IRA at the time of the parent's death.

If the client and child were informed of the advantages of stretching the inherited IRA and did in fact plan to stretch the inherited IRA, the second-to-die policy, while still a good idea, wasn't as favorable as represented. It can be difficult to convince a client of the advantage of paying for life insurance premiums using taxable IRA distributions. This is where a detailed analysis helps. "Benefits of Pension Rescue Under Current Law," this page, assumes that the law hasn't changed and the beneficiary stretches the IRA for the remainder of his life.

Benefits of Pension Rescue Under Current Law

The advantage of paying for life insurance premiums using taxable IRA distributions isn't as clear



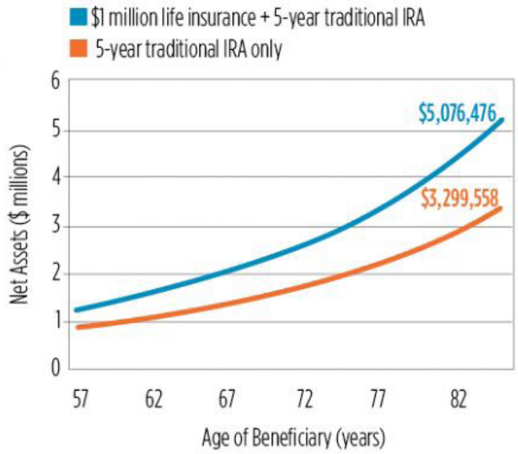
— James Lange

The blue line represents the child's wealth when he's left a $1 million life insurance policy and the remainder of the IRA. The orange line represents his wealth from the IRA that wasn't reduced by the amount of the life insurance premiums.

If the "death of the stretch IRA" legislation does pass, the old pension rescue strategy will shine. "Benefits of Pension Rescue Under Proposed Law," below, shows the child's inheritance under the new law if your client dies with a large IRA and no life insurance, as compared to making regular withdrawals from the IRA and using the proceeds to purchase a second-to-die life insurance policy that will be left to the children.

Benefits of Pension Rescue Under Proposed Law

It's worth using taxable IRA distributions to pay for life insurance premiums



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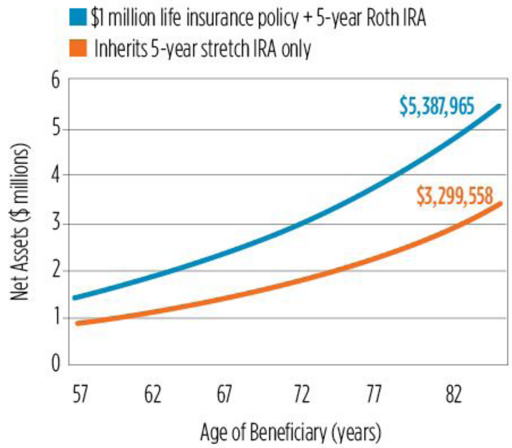
The second-to-die policy has merit under the existing law, but is even more favorable under the proposed law.

A Combined Approach

Let's look at the advantage of combining Roth IRA conversions and second-to-die life insurance. "Advantages of a Combination," this page, compares the value of the inheritance after a series of Roth IRA conversions and the purchase of a $1 million second-to-die life insurance policy with the value of the inheritance if the parents neither purchased life insurance nor made any Roth IRA conversions.

Advantages of a Combination

Using both strategies increases the retirement savings



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The blue line assumes that the parents annually converted $26,000 of the traditional IRA to a Roth IRA for the five years between ages 65 (right after they retired) and 70 (the year they started to collect Social Security benefits and took RMDs from the IRA).

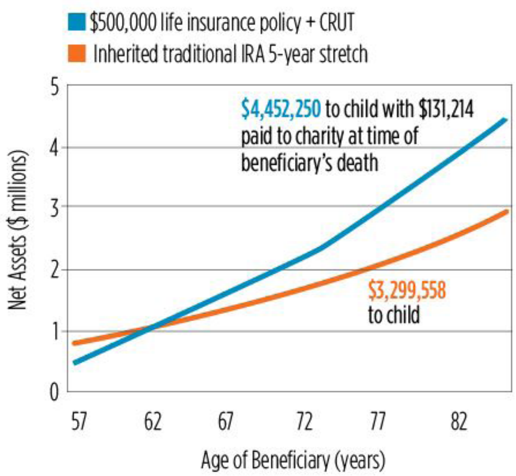
After the parents die, they leave all their IRAs, traditional and Roth, to their children. The children pay the income taxes on the inherited traditional IRA within five years after the parents die. The proceeds are reinvested in a non-qualified account that earns a 6 percent rate of return. Each child doesn't touch her inheritance, but instead allows it to accumulate.

CRUT and Life Insurance

Last month's article on CRUTs discussed their advantages in the face of the death of the stretch IRA. Let's look at what can be done when you combine powerful estate-planning tools like CRUTs and life insurance. "CRUT and Life Insurance," next page, demonstrates the difference between a child who inherits a $1 million IRA and stretches it for a maximum of five years versus a child who's the beneficiary of a $500,000 life insurance policy, as well as the maximum possible income from a CRUT that was the beneficiary of the balance of the IRA (after the withdrawals for the life insurance premiums).

CRUT and Life Insurance

Using this combination increases the long-term value of the inheritance by more than $1.1 million



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The blue line of this chart assumes that the CRUT is named as the beneficiary of the IRA and that the child is the income beneficiary of the CRUT. In addition, the blue line assumes the parents purchased a $500,000 second-to-die life insurance policy and paid for the premiums by making taxable withdrawals from their IRA. The orange line assumes the parents didn't buy life insurance and left only their IRA to their child.

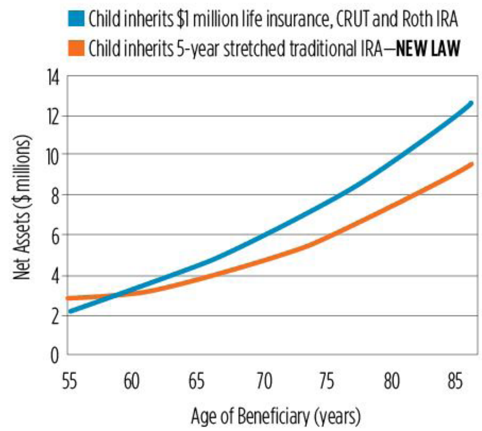
In both scenarios, after income taxes are paid, the remaining inheritance is reinvested in a non-qualified account that pays 6 percent. Even though the charity receives $131,214 of the inheritance at the child's death, combining the benefits of the life insurance and stretching the IRA inside the CRUT increases the long-term value of the inheritance to the child by more than $1.1 million.

Remember, naming the CRUT as the beneficiary of the IRA isn't without risk. If the child dies at a young age, the principal of the trust will go to the charity named as the remainder beneficiary and not to the family.

Life insurance, charitable remainder trusts and Roth conversions can, when used individually, make a noticeable difference in the wealth that's ultimately passed down to the next generation. When a combination of strategies is implemented, the difference can be so significant that they're certainly worth discussing with your client—especially if the stretch IRA is eliminated. "A Well Thought Out Plan," this page, assumes that the proposed law is passed and illustrates the possible outcomes for a client who has an IRA worth $1.5 million and an after-tax account worth $500,000. The blue line shows the advantage to his child if the client implements a well thought out plan that includes a series of Roth conversions, the purchase of life insurance paid for from the IRA and a charitable remainder trust that was named the beneficiary of the IRA. The orange line shows the outcome if the parents don't buy life insurance, don't do Roth conversions and name their child, instead of the CRUT, as the beneficiary of their IRA.

A Well Thought Out Plan

Create a noticeable difference in the wealth that's passed down



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A Variety of Options

The stretch IRA has or should have been a cornerstone of sound estate planning for IRA owners. It's come under attack in recent years, and most experts agree that it's likely to vanish very soon. If your client's children are doomed to forgo the stretch and will have to pay the income tax on inherited IRAs within five years of the IRA owner's death, they'll have far less wealth. CRUTs, Roth IRA conversions and life insurance, or preferably some combination of the above, can significantly add to your client's legacy. Roth IRA conversions and second-to-die life insurance could be implemented now in anticipation of the death of the stretch IRA. The CRUT should be on your client's radar, but shouldn't be drafted until after the law changes.

Endnote: 1. Ed Slott, Episode 152 of *The Lange Money Hour*; Natalie Choate, Episode 32 of *The Lange Money Hour*; Robert Keebler, Episode 123 of *The Lange Money Hour*; Mary Beth Franklin, Episode 111 of *The Lange Money Hour*; Jonathan Clements, "Death, Taxes and Your IRA Ouch," *Wall Street Journal* (June 11, 2015); Jane Bryant Quinn, Episode 20 of *The Lange Money Hour*; Bruce Steiner, "Roth Conversions Are More Attractive Under ATRA," *Trusts & Estates* (April 2013), at p. 13; Kaye Thomas, *Go Roth!* Fairmark Press, Inc. (2015); Elaine Floyd, Episode 39 of *The Lange Money Hour*; Barry Picker, Episode 24 of *The Lange Money Hour*; and John Bledsoe, Episode 31 of *The Lange Money Hour*.