

Old Strategy, New Twist

Leveraging life insurance as an alternative to a Roth conversion

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Synopsis

To convert or not to convert – that is the question many clients are asking as a result of a recent tax law change allowing higher-net-worth clients to convert a traditional IRA to a Roth IRA. This rule change eliminated the \$100,000 income limitation on those wishing to convert from the tax-deferred growth of a traditional retirement account to the tax-free growth available in a Roth IRA. However, the income tax bite on the conversion has proven too much for some clients, even if the tax is payable in equal installments between 2011 and 2012.

Is there a third option for clients who have rejected the Roth conversion because of its negative income tax implications? IRA Maximization (IRA Max) may be an attractive alternative to a Roth conversion for higher-net-worth clients who have clearly earmarked their IRA as a “leave-on asset” that is not expected to be needed for retirement expenses.

Traditional IRA owners must take annual distributions upon turning age 70½, known as required minimum distributions (RMDs), which are calculated based on actuarial life expectancy tables provided by the IRS. As a result of being forced to take these distributions, the leave-on value of the traditional IRA may be eroded over time. Further erosion may occur at death due to income and estate taxes, reducing the balance by as much as 70% before it is distributed to heirs.

The IRA Max strategy leverages a portion of the RMDs to purchase life insurance in an irrevocable life insurance trust (ILIT). Because this trust is irrevocable, the insurance proceeds will pass to the trust’s beneficiaries free of estate taxes. Combining this feature with the income tax-free death benefit that life insurance provides may give the IRA Max an edge for clients looking to decrease federal estate taxes and increase the amount of wealth passing to the next generation.

Assumptions

We made the following assumptions about a hypothetical married couple who have considered a Roth conversion as a wealth transfer strategy, but were discouraged by the accelerated income taxes:

- Both spouses are 71 years old and qualify for standard non-smoker rates for purposes of life insurance underwriting.
- Their balance sheet includes a \$1,000,000, “leave-on” traditional IRA, along with a non-qualified investment account of \$400,000. (It is generally recommended that the income tax payable on a Roth conversion comes from a source outside of the traditional IRA account.)
- The assumed annual rate of appreciation in both accounts is 6%.
- This year’s (after-tax) RMD is scheduled to be approximately \$28,000.
- Their current combined state and federal income tax bracket is 30%, but the Roth conversion would push them into a 40% bracket in 2011 and 2012.
- We have assumed that this higher-net-worth couple will incur federal estate taxes at death on both the qualified and non-qualified accounts, regardless of the exemption level when they die. The assumed federal estate tax rate is 45%.
- Finally, we also factored in the income tax deduction for estate taxes attributable to the traditional IRA in scenarios where the Roth conversion is not elected.

Alternate Scenarios

Our focus in this analysis centered on how much wealth may be transferred to the next generation under three scenarios when factoring in income and estate taxes:

1. Maintain Traditional IRA.

Maintain the existing traditional IRA, adding after-tax RMDs to the non-qualified account.

- ### 2. Roth Conversion.
- Convert the traditional IRA to a Roth IRA in 2010, triggering \$400,000 in combined state and federal income taxes, payable in equal installments in 2011 and 2012. These income taxes are paid from the non-qualified account (for reasons discussed above).

- ### 3. IRA Max.
- Maintain the existing traditional IRA and use a portion of the after-tax RMDs to pay a \$26,000 annual life insurance premium. These premiums are used to purchase \$1,400,000 of survivorship universal life insurance with a lifetime guaranteed death benefit (SGUL) in an ILIT. Guarantees are subject to the claims-paying ability of the insurer, and all required premiums must be paid on time and as scheduled to maintain these guarantees. It is also assumed that the payment of the \$26,000 annual insurance premium would be absorbed by the couple’s ability to make annual gifts of up to \$13,000 to each of their two children under current gifting rules.

Comparing Results

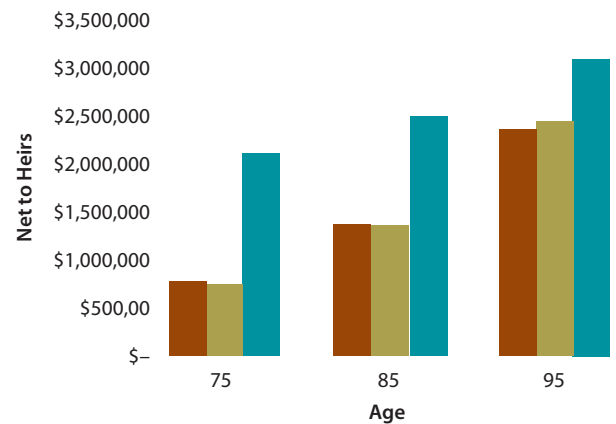
As noted, we focused on the amount of wealth transferred to the next generation after income and estate taxes are deducted. Not surprisingly, the IRA Max leads the way early on because the internal rate of return (IRR) on the death benefit is significantly greater in the earlier years (138% IRR at ages 75) and diminishes as the clients near anticipated mortality (9.5% IRR at ages 90). Although the Roth Conversion gains relative momentum in the later years, our analysis indicates that the IRA Max still provides a greater amount of after-tax wealth transfer to the clients' heirs through age 95. As Graph 1 demonstrates, the IRA Max tops the Roth conversion as a wealth transfer strategy by approximately \$1.4 million at age 75, \$1.1 million at age 85, and \$625,000 at age 95.

GRAPH 1:

Net Amount to Heirs

Age	Maintain IRA	Roth Conversion	IRA Maximization
75	\$802,000	\$769,000	\$2,123,000
85	\$1,390,000	\$1,372,000	\$2,480,000
95	\$2,366,000	\$2,450,000	\$3,074,000

■ Maintain IRA
■ Roth Conversion
■ IRA Maximization



A True Apples-to-Apples Comparison

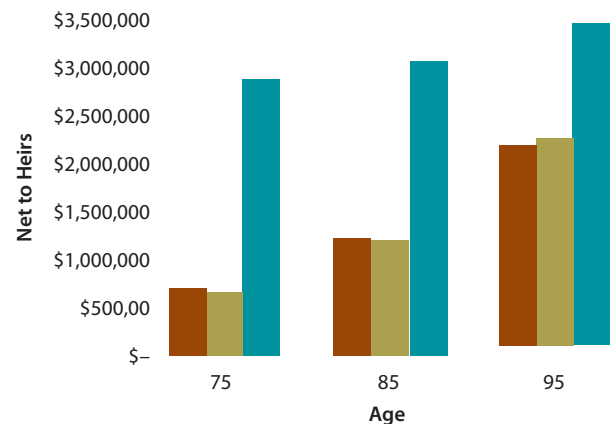
In the above analysis, our hypothetical clients rejected the Roth conversion because they balked at the \$400,000 income tax liability. However, to truly compare the two strategies, we would redirect the \$400,000 that would have been paid in income taxes on the conversion into the life insurance policy. This would double the amount of life insurance purchased to \$2.8 million, resulting in an increased net amount to heirs of approximately \$2.5 million at age 75, \$2.1 million at age 85 and \$1.3 million at age 95, as shown in Graph 2.

GRAPH 2:

Net Amount to Heirs

Age	Maintain IRA	Roth Conversion	IRA Maximization
75	\$802,000	\$769,000	\$3,272,000
85	\$1,390,000	\$1,372,000	\$3,467,000
95	\$2,366,000	\$2,450,000	\$3,795,000

■ Maintain IRA
■ Roth Conversion
■ IRA Maximization



Additional Considerations

Obviously, results will vary with changes in the multiple assumptions made in the analysis, but the ability to remove assets from the federal estate tax system seems to make the IRA Max strategy compelling as an alternative to the Roth conversion, at least for some clients. We also note the following:

- The results were more favorable for married clients who can leverage a life insurance purchase with survivorship life insurance. Results were still favorable for a single female, but slightly less compelling for a single male.
- Increasing the anticipated rate of return improved the outcome of the Roth conversion over time.
- Increasing income tax rates incrementally narrowed the spreads between the two strategies.
- Similarly, higher life insurance premium rates would also narrow the spreads.

- However, increasing estate tax rates improved the result of the IRA Max because of the critical removal of the insurance proceeds from the client's taxable estate.
- Finally, the IRA Max strategy still projected favorably for a younger client who had not reached RMD status.

Summary

We did not set out to establish flaws in the Roth conversion strategy, or to show that one strategy is superior to the other. Our goal was to objectively compare the amount of wealth that could be transferred to the next generation under these different scenarios when both income and estate taxes are considered. As our results have demonstrated, the IRA Max strategy may be a critical consideration when deciding whether or not to convert from a traditional IRA to a Roth IRA.

Consult with your Baird Financial Advisor to learn more about these and other planning opportunities.

ABOUT THE AUTHORS:

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