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Advanced Markets

Planning in Action

Roth conversion

Success Story

Case in point

An agent called Advanced Markets to discuss a client who has a large IRA and is concerned about the impact of income taxes. The client does not need the IRA for current or future retirement income and was planning to leave it as a legacy to their heirs. Given the potential for income tax increases under proposed legislation, especially at the upper income levels, the agent and the client want to consider converting their Traditional IRA to a Roth IRA to pay the taxes now at the lower marginal rates.

The goal is to determine the highest potential legacy to the heirs by either: 1) do no further planning and retain the current IRA as is; 2) convert to a Roth and pay taxes at the current marginal tax rate; or 3) retain the IRA and use taxable distributions to buy Life Insurance.

Designing a case

The analysis consisted of 3 Options:

1. **If the clients do no further planning with their IRA,** and start taking RMDs at age 72, the net to heirs at their joint life expectancy would be $6.25M as calculated below.
   - At age 72 their $3M IRA growing at 6% would be $3.37M.
     - Their first gross RMD would be $131,672 and after taxes they would net $79,003.
     - We assume they deposit the after-tax RMDs into a retained side-fund growing at 3.6%.
   - At their joint life expectancy, age 92
     - The retained side fund would be about $3.9M and is assumed to pass to the heirs income tax free.
     - The IRA balance of $3.2M would be subject to IRD taxes of $890k.
     - The total inheritance would be $6.25M after taxes.

Client profile

- Husband and wife, both age 70 Preferred Non-Smoker
- Derive income from pensions and social security, have not taken distributions and have no need for additional income from the IRA.
- Concerned about income tax consequences of RMDs at age 72.
- Want to leave a legacy for their three children.

Fact finding

- Current net worth $10M, includes $3M Traditional IRA.
- Average annual return on IRA is 6% and after-tax return of 3.6% on non-qualified assets.
- Current combined state and Federal income tax is 40%, would rise to 50% in year of Roth conversion.
- Beneficiaries would be assessed a tax of 28% on liquidation of inherited IRA.

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2 **If the clients choose to convert their Traditional IRA to a Roth IRA**, they will have to pay income taxes on the amount converted. This conversion will increase their taxable income in the year converted and result in a combined tax rate of 50%. Based on the $3M value of the IRA this will mean they will have an additional $1.5M tax liability in that year.

Where will the additional tax payment come from?

A. *From other estate assets,* the client would need to liquidate about $2M to net the $1.5M needed on an after-tax basis (assuming a 25% combined capital gains rate).

- Assume the $2M other estate asset has an after-tax growth rate of 4.8%, liquidating the asset to pay taxes would result in lost opportunity costs of about $5.9M at life expectancy.
- However, the entire $3M IRA balance will roll into the Roth and would grow to about $11.5M at life expectancy, assuming annual return of 6%.
- When you factor in the lost opportunity costs and growth of the Roth assets, the net from planning would be about $5.6M.

B. *From the IRA assets,* then the $3M IRA balance will be reduced to a $1.5M Roth IRA.

- Assuming the same 6% growth rate, the Roth balance will be $5.7M at life expectancy.
- However, they don't have to liquidate other estate assets and they don't lose the $5.9M opportunity costs from doing so.
- The net from planning under this scenario would be the $5.7M.

The choice for how to pay the additional tax liability resulting from conversion provides very similar results:

A. From other estate assets: Gross Roth of $11.5M, with net estate of $5.6M given loss of liquidated estate asset.

B. From the IRA assets: Gross Roth of $5.7M, plus $5.8M estate asset not liquidated, for a total of $11.5M.

Keep in mind that the same 5- and 10-year rules for the distribution of IRA assets also applies to inherited Roth IRAs. This means that the original Roth account assets must have been held in the account for at least 5 years prior to the distribution to qualify for Roth treatment and avoid income tax on the earnings. In addition, the inherited account must still be liquidated within a 10-year time frame from the death of the original owner.

3 **If the clients use RMDs from their current IRA to purchase life insurance**, they may enhance the total value for their heirs.

- Starting immediately, the client would take a withdrawal from their IRA in the amount of $116,667 which will provide an after-tax value of $70K.
- They will use the $70k to purchase a $4M Protection SIUL policy and pay the annual premium of $70K.
  - If we assume the insurance is held inside an ILIT, the client will make annual exclusion gifts of this amount each year and the Trustee would pay premiums on the policy (The clients could also elect GST exemption and add grandchildren as beneficiaries.)
- If future RMDs exceed the amount required for the annual premium, the excess RMD would be retained in a side fund account growing at an average annual after-tax return of 3.6%.
- At joint life expectancy (age 92)
  - The retained side fund would be about $1.4M and is assumed to pass income tax free to the heirs.
  - The IRA balance of $2.8M would be subject to IRD taxes of approximately $795k.
  - The ILIT would receive the tax free death benefit of $4M.

When you add in the life insurance of $4M, the total value passing to the heirs is about $7.45M. Under this option, since we have chosen to pay the taxes on the IRA distributions from IRA assets, we can also assume the other retained estate asset from choice B above, valued at 5.9M at life expectancy, would also pass to the heirs. In total, this would increase the amount transferred to the heirs to about $13.35M. Also note that there is no required 5- and 10-year distribution rule for the ILIT assets or the retained side fund, which allows for additional tax and legacy planning on behalf of the client.

Why it works

In many cases, especially at older ages, Roth conversions may not be the most efficient method to minimize taxes and enhance legacies. This is due in part to:

- Not enough time to recover the tax cost of the Roth Conversion
- Potential higher marginal income tax rate in the year of the Roth conversion
- "Stretching" the income tax payments from retained IRA's offset by the tax deferred growth of the IRA minimizes income taxes currently.

Benefits:

- Gifts of the annual premium reduces the estate values which could reduce estate taxes at death.
- Attractive IRRs on Life Insurance. In this design, the IRR on the premium stream at life expectancy is 6.41%.
- ILIT provides flexibility to the grantor as the trustee can "stretch" any payments to trust beneficiaries. If GST is elected, the Grantor can create a legacy for multiple generations.
  - Having the ILIT in place also allows the clients to take a wait-and-see approach to estate tax planning to allow for accelerated funding of the ILIT to use their lifetime exemption if future legislation decreases the exemption limits.

Outcome

The client, after reviewing the analysis from the Roth Conversion Analysis decided on option 3 (Retain the IRA and buy Life Insurance) and the application was taken by the agent.

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Call Advanced Markets at *888-266-7498, option 3* to speak with an Advanced Markets Consultant, or email *advancedmarkets@jhancock.com*