Managing the Tax Consequences of Large IRAs: The Emergence of Integrated Solutions*

By Daniel A. Guglielmo, Ronald B. Ware and Scott Hamilton

Daniel A. Guglielmo, Ronald B. Ware and Scott Hamilton discuss the emergence of large IRAs as the most prominent asset in many estates and strategies that may be employed to optimize wealth transfer to the beneficiaries.

The emergence of the large individual retirement account (IRA) is a unique challenge facing the professional planning community. For this article, we define a large IRA as one valued in excess of $1 million. From a post-retirement strategic planning perspective, these IRAs often represent a disproportionate part of the individual estate. Of greatest concern are large IRAs owned in a taxable estate that exceeds $2 million for married couples under current law. Most often, these clients have little need or desire to access the IRA for retirement income, which only serves to magnify the need to manage the growing income and estate tax liability.

The complex regulations governing qualified retirement plans have historically created a barrier to the use of popular estate planning tools. For many families, the retirement asset is often their largest and most important asset. Taking advantage of the significant benefits of trusts, partnerships and corporations with IRAs is challenging. Fortunately, the professional planning community is beginning to find creative ways to hurdle the barriers imposed by the regulations. This article provides some theory behind the emergence of large IRAs

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and the many pitfalls that may be encountered in working with these accounts, outlines the traditional approaches used to address these problems and surveys several integrated solutions that the authors have observed in this developing marketplace.

The tax consequences posed by large IRAs can be devastating to clients and their families. To be sure, thoughtful and creative planning is needed to manage the tax risk.

It is important to note that although this article specifically addresses the taxation of large IRAs, each of the strategies reviewed by this article addresses many other significant family planning objectives as well. The nontax virtues of these strategies are also briefly noted.

The Growth of Large IRAs

The primary factor responsible for today's pool of large IRAs is the transition in employee benefit packages over the past two decades from traditional pensions, defined benefit (DB) plans, to 401(k) plans and other defined contribution (DC) plans. This change allows employees to enjoy higher-than-expected returns on their retirement assets, while also retaining greater control. Employers encouraged this transition to escape the costs associated with guaranteed pension funds (DBs).

Between 1983 and 1998, the percentage of older working households[1] covered by qualified retirement plans increased from 72 percent to 74 percent,[2] a modest two percentage point increase. Over the same time period, participation in DC plans among these households rose from 11.9 percent in 1989 to 59.7 percent in 1998, an increase of 47.8 percentage points.[3] On an individual level, the average balance of these plans for older workers grew from $8,258 in 1983 to $69,200 in 1998, up over 88 percent.[4] Participation in DB plans decreased by 27 percentage points over the same time period,[5] suggesting a wide-scale shift in employee retirement plans from DBs to DCs among these households. Among younger households the difference may be even more pronounced.

But IRAs are not DC plans, so how does this historical shift in the qualified plan world explain the presence of over-funded IRAs? Two reasons: DC rollovers and simplified employee pension plans (SEPs). Because an IRA can be owned and managed by the retiree, a rollover into an IRA is often the most attractive option available for an employee's DC assets upon termination of employment from a particular company. The reason to choose a DC plan over an IRA during the working years, is that a 401(k) plan normally permits greater contributions than could be made to an individually held IRA. A DC participant can defer up to $11,000 annually in 2002 of otherwise taxable income into his or her 401(k), while an IRA owner can only contribute and deduct $3,000 in contributions each year. What has really caused the growth in IRA accounts over the past number of years has been the rollover provision for qualified plans, which permits a retiring employee to roll his accumulated qualified plan balance over to an IRA. Another source of large IRA balances is from SEP IRA accounts. These are essentially IRAs with a 401(k) contribution limit. They were designed to allow small employers to provide 401(k)-like benefits to their employees with reduced administration costs. SEPs can also be rolled into IRAs at retirement.

Over-concentrated positions of company stock within DC plans during the hyper-growth periods of the 1990s is a third factor contributing to the pool of large IRAs, for those who were fortunate enough to diversify before the recent stock market correction.

In 1999, the U.S. 401(k) market alone totaled over $1.5 trillion in value, more than 300 percent higher than 13 years prior,[6] evidence of both the widespread creation and rapid accumulation of such plans over that time period. At the millennium, the overall U.S. qualified retirement market totaled approximately $11.5 trillion, with $2.6 trillion held in DC plans and $2.6 trillion in IRAs—a combined total of 46 percent of the overall market and growing. Although current market volatility may temporarily slow employers' abilities to transition more employees from pensions to DC plans, the market is sure to continue in this direction when the bulls return. Large IRA rollovers will continue to follow. It is essential that planning professionals understand the consequences that large IRAs present, and develop integrated strategies that effectively manage the resulting tax, legal and financial risks.

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IRA Taxation at Death— A Growing Problem

IRAs (and all qualified plans) could be subject to the double taxation of income and estate tax. An IRA owner may conclude, "double taxation won't happen to me." After all, many IRA owners know, the minimum distribution incidental benefit (MDIB) rules were drafted by Congress to ensure that the federal government gets its piece of the pie before the IRA owner dies. By forcing the IRA owner to deplete his IRA before reaching his life expectancy, the government is sure to receive its portion. If an IRA owner supposes that he will be forced to take all of the IRA money out of his IRA prior to death, then it is easy to see why he may ignore the perils of double taxation.

This belief stems from an improper understanding of the MDIB rules, and amounts to little more than wishful thinking. Two faulty assumptions are at play here: first, that the participant will live to his life expectancy,[7] and second that the IRA balance will decrease once minimum distributions begin. Chart 2 illustrates how an IRA balance will continue to increase after the onset of minimum distributions.[8] In this example, the IRA balance at life expectancy is approximately 150 percent of the IRA balance at the time minimum distributions began.[9] Because minimum distributions are approximately four percent of the plan balance in the early years and gradually increase each year, assets within this plan continue to grow until the participant reaches his late 80s. Although the distribution percentage increases annually, it will take 18 to 19 years for the distribution percentage to equal the IRA's internal growth rate.

With this sobering data in mind, IRA tax management should not be ignored, especially in larger estates where, without careful planning, the double-tax ax is likely to fall.

The best way to understand the tax risk is to look at an example. (Note that in this article, we will focus our examples on single IRA owners, rather than married couples. The reason for this is that married couples with large IRAs tend to be able to delay the tax through a combination of the unlimited marital deduction, which allows spouses to pass unlimited amounts of property to each other during life and at death without estate tax, and the IRA spousal rollover provisions of the income tax code, which permits a surviving spouse to roll their deceased spouse's IRA into their own IRA without income tax.)

Chart 1

Year of Contribution	IRA Contribution Limits	DC/SEP Contribution Limits
Pre-2002	$2,000	$10,500
2002	$3,000	$11,000
2003	$3,000	$12,000
2004	$3,000	$13,000
2005	$4,000	$14,000
2006	$4,000	$15,000
2007	$4,000	$15,500
Post 2007*	$5,000	$16,000

*Both IRAs and DC contribution limits will increase by $500 per annum following 2008 to adjust for inflation.

Chart 2
Account Growth Faster Than Minimum Distributions

Year	Age	Beginning IRA Balance	8% Growth	Minimum Distributions	Ending IRA Balance
1	71	$5,000,000	$400,000	($188,679)	$5,211,321
2	72	$5,211,321	$416,906	($203,567)	$5,424,659
3	73	$5,424,659	$433,973	($219,622)	$5,639,010
4	74	$5,639,010	$451,121	($236,933)	$5,853,198
5	75	$5,853,198	$468,256	($255,598)	$6,065,855
6	76	$6,065,855	$485,268	($275,721)	$6,275,403
7	77	$6,275,403	$502,032	($296,010)	$6,481,426
8	78	$6,481,426	$518,514	($319,282)	$6,680,658
9	79	$6,680,658	$534,453	($342,598)	$6,872,513
10	80	$6,872,513	$549,801	($367,514)	$7,054,800
11	81	$7,054,800	$564,384	($394,123)	$7,225,061
12	82	$7,225,061	$578,005	($422,518)	$7,380,547
13	83	$7,380,547	$590,444	($452,794)	$7,518,197
14	84	$7,518,197	$601,456	($485,045)	$7,634,608
15	85	$7,634,608	$610,769	($515,852)	$7,729,524
16	86	$7,729,524	$618,362	($548,193)	$7,799,693
17	87	$7,799,693	$623,975	($582,067)	$7,841,602
18	88	$7,841,602	$627,328	($617,449)	$7,851,481
19	89	$7,851,481	$628,118	($654,290)	$7,825,309

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Assume a client owns a $5 million IRA with a $6 million gross estate. The IRA represents about 83 percent of the estate. Further assume the IRA owner is single and has previously used his exemption equivalent. In addition, assume that there are no state death or income taxes. With no planning, if death occurs in 2002, this client's IRA would be subject to a $2,046,900 estate tax.

Assume further that either the client named his estate the beneficiary of his IRA, or that his heirs elected to take a lump sum distribution. The remaining IRA balance after estate taxes will then be taxed again as income to either the estate or the heirs.[10]

Total taxation from estate and income taxes in this example is $3,186,797, which amounts to 63.7 percent of the IRA and 53 percent of the estate.

Many clients are looking forward to estate tax repeal as a planning solution. However, even if the estate tax is permanently repealed, the income tax consequences will be significant enough to compel action. Without an estate tax credit, the effective income tax increases from 22.7 percent to 38.6 percent, yielding an income tax in the above example of $1,930,000.

The conclusion? The tax consequences posed by large IRAs can be devastating to clients and their families. To be sure, thoughtful and creative planning is needed to manage the tax risk. However, care should be taken when choosing the tools or strategies to make sure that the client's overall objectives, and not simply tax-avoidance, are the plan's guiding force, as each strategy or tool inherently solves multiple objectives.

Common Approaches to Managing the Tax Risk

Several common planning approaches quickly come to mind to manage the large IRA tax risk. A frustrated client may just want to abandon his IRA, pay the income taxes and be done with the complex MDIB process. The more knowledgeable consumer who reads the financial journals may be eager to create a multi-generational, or stretch, IRA. A stretch can substantially lengthen the life of the IRA, extending the tax-deferral period. Another more generous client may choose to gift away the double taxation by donating his IRA to charity. Because of the charitable deduction, gifting can eliminate both the estate and income taxes.

The following section analyzes each of these "common" solutions to the large IRA problem.

Get out of Dodge

Abandoning the IRA and taking the tax-lump now is one possible option. The following example compares leaving IRA funds intact inside of the IRA over a 10-year period as against a lump sum distribution. The third example looks at a Roth conversion. Unfortunately, a Roth conversion option is not usually available to the large IRA client, because of the annual income limits imposed by the regulations. The conclusion is that deferral is better than lump sum distributions, and that a Roth conversion, if possible, provides slight benefits over simple deferral.[11]

Stretch It to the Max—If You Can't Beat 'Em Join 'Em

If preservation of the IRA's tax-free sanctuary is the client's primary concern, applying the minimum distribution rules provided by the federal government to "stretch" the maximum life out of the IRA is the first order of business. Chart 6 compares the results of stretching to not stretching on both an absolute and a net-present-value (NPV) basis.

Chart 3
Death in 2002

Taxable Estate Assets	**$6,000,000**
IRA Assets	$5,000,000
Non-IRA Assets	$1,000,000
Estate Tax	**($2,046,900)**

Chart 4
Death in 2002

Taxable Estate Assets		**$6,000,000**
Non-IRA Assets		
		$1,000,000
IRA Assets		$5,000,000
Estate Tax*		**($2,046,900)**
Income from IRA		$5,000,000
Credit for Estate Taxes Paid		($2,046,900)
Adjusted Income		$2,853,100
	Income Tax	**($1,139,897)**
Total Taxes Attributable to IRA at death		**($3,186,797)**

* Note that 100 percent of estate taxes in 2002 would be attributable to the IRA.

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As powerful as this example may be, the professional planner must be mindful that the stretch IRA manages only the income tax; it does nothing to manage the estate tax. This is significant since the highest estate tax bracket trumps the highest marginal income tax bracket. Accordingly, the large IRA presents a substantial obstacle to the client's wealth transfer plans at death.

Charitable Distributions of IRA Assets—An Easy Way to Give a Lot

Donating an IRA to charity can be a potent planning option because the donor receives significant tax leverage in exchange for his gift. A planned giving officer in a charitable foundation might do well by asking his donor base the following question:

> If it cost you only $0.25 to give $1 to your favorite charity, would you give more?

Donating an IRA to a charity provides such an opportunity—two gifting possibilities exist. The first—lifetime charitable gifting with IRA funds—involves taking a taxable distribution prior to gifting the IRA proceeds. However, the gift is income tax deductible, within certain limitations, which will help offset the income tax caused by the distribution from the IRA. Once the funds are gifted, they are no longer a part of the estate, yielding estate tax benefits. The second gifting possibility is a testamentary gift. This type of gifting plan can give the donor the comfort of access to the IRA funds during his lifetime, knowing that at death, the gift will qualify for a complete income and estate tax charitable deduction. As a result, in a large estate where more than

Chart 5

Future Bequest: Assets Kept in IRA	
Initial IRA Balance	$1,000,000
Future Balance in 10 years	$1,967,151
Estate Tax	$ (840,650)
Income Tax	$ (411,028)
Net to Heirs	**$715,473**
Future Bequest: Assets Withdrawn & Reinvested	
Withdrawn IRA Balance	$1,000,000
Income Tax Paid	$(362,199)
Initial Balance to Invest	$637,801
Future Balance in 10 years	$1,142,205
Estate Tax	$(473,555)
Net to Heirs	**$668,650**
Future Bequest: Assets Withdrawn & Invested in Roth	
Initial IRA Balance	$1,000,000
Present Income Tax	$(362,199)
Initial Balance to Invest	$637,801
Future Balance in 10 years	$1,254,652
Estate Tax	$(523,256)
Net to Heirs	**$731,396**

Chart 6
*IRA Stretch Comparison**

Year	Non-Stretch Balance	Stretch Balance	Stretch Advantage (Absolute Basis)	Stretch Advantage (NPV Basis)
1	$644,770	$656,873	$12,103	$11,311
2	$681,522	$707,254	$25,733	$22,476
3	$720,369	$761,412	$41,043	$33,504
4	$761,430	$819,624	$58,194	$44,396
5	$804,831	$882,188	$77,357	$55,155
6	$850,707	$949,411	$98,704	$65,771
7	$899,197	$1,021,647	$122,450	$76,256
8	$950,451	$1,099,265	$148,814	$86,611
9	$1,004,627	$1,182,639	$178,012	$96,827
10	$1,061,890	$1,272,209	$210,318	$106,915
11	$1,122,418	$1,368,428	$246,010	$116,878
12	$1,186,396	$1,471,758	$285,362	$126,704
13	$1,254,021	$1,582,741	$328,720	$136,407
14	$1,325,500	$1,701,904	$376,404	$145,976
15	$1,401,053	$1,829,874	$428,820	$155,424
16	$1,480,913	$1,967,254	$486,340	$164,740
17	$1,565,325	$2,114,723	$549,397	$173,925
18	$1,654,549	$2,273,054	$618,505	$182,993
19	$1,748,858	$2,442,986	$694,128	$191,932
20	$1,848,543	$2,625,354	$776,810	$200,743

* Assumes a beneficiary age 51 at time of inheriting IRA; IRA balance at inheritance—$1million; income tax rate on lump sum distribution—39 pecent; income tax rate on stretch plan—25 percent; assumed turnover on taxable accounts—20 percent; growth rate-IRA—seven percent; growth rate-non stretch—six percent. All sums distributed are re-invested, not consumed. NPV interest rate is seven percent. Advantage is pre-income tax.

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75 percent of the IRA could be lost to double taxation, the real cost of giving away one IRA dollar to charity is effectively only 25 cents.

The Real Answer to the Large IRA Problem—The Emergence of Integrated Solutions

Abandoning the IRA and paying the tax today, stretching it to defer taxation or giving it to charity instead of the government are all common planning options. However, these options often leave the owner of a large IRA unsatisfied. Given the 75-percent taxation facing many large IRAs, it is no surprise to learn that a number of innovative alternatives are emerging from the planning community. Several of these are detailed below. Each alternative represents an attempt to provide an integrated solution, tailoring tax, legal and financial components to meet specific family objectives beyond tax management alone.

Donating an IRA to charity can be a potent planning option because the donor receives significant tax leverage in exchange for his gift.

Unitrust Plan

Charles Shultz, president of Crescendo Interactive, Inc.,[12] has demonstrated that we can improve upon the results offered by a traditional stretch IRA by designating a charitable remainder unitrust as an IRA beneficiary. The stretch unitrust is compelling for its simplicity and for the quality of the taxation associated with the income stream that this strategy delivers. Unlike a stretch IRA, a stretch unitrust provides the additional benefits of estate tax relief and the promotion of charitable interests.

A stretch unitrust provides a superior income stream to a stretch IRA for two reasons. First, a significant portion of the income from a properly designed and managed stretch unitrust is considered long-term capital gains,[13] while distributions from a traditional stretch IRA must be reported as ordinary income. Secondly, a stretch unitrust can provide a more consistent income stream over the life of the beneficiary, which may more adequately meet a client's planning objectives.

The stretch unitrust can deliver a superior income stream because it has unique tax attributes. When designed as a net income with makeup charitable remainder unitrust (NIMCRUT), granting the trustee the discretionary power to convert long-term capital gains into ordinary income or corpus, the trustee can implement an investment plan that will intentionally "push through" the ordinary income during the early years of the trust. Properly managed, the unitrust should then be able make distributions that will be taxed largely as capital gains.

For example, consider a widow with one child who has a $3 million estate, $1 million of which is held in an IRA. At death, the IRA passes by beneficiary designation to a seven-percent unitrust designed to pay out for the rest of her child's life. The child is 50 at the time of her mother's death. The estimated income from the stretch unitrust over 33 years would be approximately $6 million. Had the widow selected the traditional IRA stretch instead, approximately $6 million would have also been paid out. The difference between the two approaches is that in the traditional stretch all of the income would be taxable as ordinary income. With the stretch unitrust, only the first $1 million would be paid out as ordinary income. The majority of distributions thereafter would be taxable as long-term capital gains.

The present value of all unitrust income payments would be approximately $2.59 million, whereas the present value of all income payments from the traditional stretch IRA would be approximately $2.32 million. The stretch unitrust not only delivers more economic value, it also continues to pay if the child lives beyond life expectancy. In addition to the benefits to her heirs, the widow will pass over $3.5 million to charity.

The Charitable Pension Plan

InsMark's[14] charitable pension approach ramps up the traditional use of an irrevocable life insurance trust (ILIT) as a wealth replacement tool for an IRA that is bequeathed to charity. The end result is an integrated solution that merges estate and income tax planning with charitable planning. This approach creatively blends some of the more traditional mechanisms of IRA distribution planning with a carefully chosen life insurance product, and sometimes an annuity.

The ILIT has long been a pillar for the estate planning community. The ILIT is an effective way to use life insurance to pay the estate tax bill. The proceeds of an ILIT-owned life insurance policy are not included in the insured's estate. If the ILIT is properly drafted, the trustee

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will have the authority to make loans to the estate, purchase property from it to provide necessary liquidity for estate tax payments or provide tax-free wealth to the beneficiaries, often by "replacing" tax deductible gifts made to charity from the insured's estate.

While the charitable pension strategy will always include life insurance, its specific design is driven by the client's personal objectives and his answer to two simple questions: (1) which product should we use? and (2) how much is enough life insurance?

The product design is tied directly to the client's risk profile and the purpose of the life insurance. If it is designed to build cash value and mirror the IRA in terms of growth and liquidity, variable life insurance should be considered. If security is the design priority, then secondary no-lapse guarantees and a universal life product may be preferred.

To determine how much insurance is appropriate, one might begin by asking the question, "how much is too much to leave the descendants?" Or, alternatively, the answer may be derived from running a stretch IRA analysis to determine the peak IRA value during life as the measure of an appropriate amount of death benefit to purchase. Once the desired death benefit is chosen, it is easy to determine the premiums. Next, we calculate the gross amount the client must withdraw from the IRA to net an after-tax amount sufficient to pay the premiums. Once the client has the funds to pay the premiums he will gift them to the ILIT. The ILIT trustee will purchase the insurance and pay the premiums from the assets gifted to the trust.

An example may be helpful. Assume that the client is age 65 and his spouse is age 60. They have a $5 million IRA and $1 million in real estate. They have also preserved their $2 million exemption at the time of plan design. Chart 7 is a comparison of the IRA stretch and the charitable pension at the client's life expectancy, age 85.

Chart 7

	Stretch IRA	**Charitable Pension**
Heirs	11.1 million	9.2 million
Taxes	11.6 million	2.2 million
Charity	0	9.2 million

Chart 7 illustrates three tangible results from the charitable pension plan: (1) the heirs get less, (2) taxes decrease significantly, and (3) charitable giving increases dramatically. However, these results alone tell only a part of the story. The quality of the asset can make a substantial difference, as we have seen in the stretch unitrust discussion. The results in this example do not account for the ordinary income tax that must be paid on all of the $11.1 million going to the heirs under the stretch IRA. If, for example, all $11.1 million from the stretch IRA was realized as income in a single year, the benefit to the heirs would decrease to approximately $6.1 million, net after tax. In contrast to the stretch IRA, the charitable pension plan produces a *true* $9.2 million benefit to the heirs because all of the proceeds have a full-cost basis.

Though we have established that the tax-adjusted economic value of the charitable pension plan is demonstrably greater than the stretch IRA results, we need not lose sight of the considerable benefits of tax deferral. Once the insurance proceeds pay into the ILIT, the trustee should consider purchasing an annuity to shelter future income tax, thus building tax deferral into the plan akin to the stretch IRA, but without the imposition of the complex MDIB rules.

The charitable benefits provided by this strategy may be the charitable pension plan's most meaningful attribute. For many clients, reduced taxation and increased benefits to the heirs will open the door to increased charitable giving. To "kick it up a notch," the family may want to consider integrating the stretch unitrust into the charitable pension plan. Rather than an outright bequest of the IRA to charity at death, the family could name a charitable remainder trust as the IRA beneficiary. This would provide an ongoing income stream to children and/or grandchildren while still leaving a sizeable IRA gift to charity in the future.

The Pension Rescue Plan

Planning with IRAs would be a lot easier if life insurance was not a prohibited investment. This statement is especially true of the large IRA. Families with large IRAs often have little or no need to rely upon the IRA for retirement, generally scorning the additional income taxes caused by the mandatory minimum distributions. These families also often desire life insurance for a variety of reasons, including the replacement of a significant portion of the IRA, which is likely to be lost to double taxation.

The pension rescue plan may be the answer to this dilemma, at least in part. The pension rescue plan is a strategy utilizing the benefits of company-owned profit sharing plans to purchase life insurance. Unlike IRAs, these

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company-owned profit sharing plans are allowed to own life insurance, within certain limitations.

The pension rescue plan requires the client to either have or form a business capable of adopting a type of DC plan known as a profit sharing plan. The client rolls his existing IRA into the profit sharing plan[15] and then simply directs the plan to use the assets to purchase life insurance.

Typically, a strategy to remove the policy from the profit sharing plan is designed into the pension rescue plan from the onset. If the insurance is not removed from the profit sharing plan before the client's death, the death benefit will be included in the estate, thus increasing estate and income taxation and defeating a primary purpose of the pension rescue plan. To avoid this result, two options are generally available. At a pre-determined date, the insurance policy can be distributed from the profit sharing plan, or one or more individuals from a specified group may purchase the policy from the plan.

Because a profit sharing plan is a qualified employee benefit plan, the client must also perform services for the business rather than merely own it. Good candidates for the strategy are those having an operating business or who consult with other businesses in their field of expertise. It is also possible for a general partner of a family limited partnership to be an employee for purposes of establishing an employee benefit plan owned by the partnership.

In addition to being an employee of a business having a company-owned profit sharing plan, the profit sharing plan document must also permit the plan to own life insurance. Once these requirements are in place, the pension rescue plan calls for the client to roll his IRA money into the company profit sharing plan. Once the IRA funds have been rolled into the profit sharing plan, the client can direct that the plan buy life insurance.

The insurance policies used with the pension rescue plan generally require between two and seven annual premium payments. These annual premium payments are made with the profit sharing plan assets. Near the end of the premium payments, the policy is distributed from the plan to remove the death benefit from the estate and avoid the additional income taxation that would otherwise be caused by the capture of the death benefit within the profit sharing plan. Removing the insurance policy from the profit sharing plan will, however, be a taxable event.[16]

The value of the insurance policy at the time of distribution is the measure of the income subject to income taxation. There is some disagreement among commentators on how to measure the value of an insurance contract at the time of distribution from the profit sharing plan. Some argue that the value of the policy at distribution is equal to the cash surrender value. Others argue that the correct value of the insurance policy is its interpolated terminal reserve (ITR), if it is a "springing cash value" policy. Generally, the ITR value will be significantly greater than the cash surrender value.

In Notice 89-25,[17] the IRS described what a springing cash value insurance policy looks like. In this notice, the IRS described an insurance policy having a low cash value relative to the large premiums paid in the first few years. In the fifth year, the cash value of the policy jumped significantly, allowing the owner of the policy to have access to most of the cash value without income tax, surrender charges or other penalties. These policies appear to be contrived for the single purpose of avoiding taxation upon distribution by causing artificially depressed cash value at the time of distribution, which then "springs" in value shortly after distribution. According to the IRS, policies with these characteristics should be valued at their ITR rather than their cash surrender value.

The policies used in the pension rescue plan are not designed like the one described in Notice 89-25. In most cases, the insurance policy will have a long surrender period with very slow release of the surrender charges and very little access to cash value. As a result, insurance policies designed for the pension rescue plan will not have the "springing" characteristics found in Notice 89-25. The corollary is that the IRA owner is limited in his or her access to cash value during lifetime.

While designing the pension rescue plan, the planner should also be cognizant of the incidental death benefit (IDB) rule, which can limit the amount of profit sharing plan assets that may be used to purchase insurance. The primary purpose of a qualified plan is to provide an employee with deferred compensation benefits on a tax-deductible basis. The IDB rule states that other benefits, such as life or medical insurance, may be provided to plan participants, but these benefits must be incidental to the primary purpose of the plan. The IDB rule applies to plan contributions, but does not apply to employee contributions[18] or to assets that may be withdrawn by

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an employee after a period of time, which must not be less than two years.[19]

The assets used to buy the insurance in the pension rescue plan are not subject to the IDB. The IDB limitation is avoided because the assets used to fund the insurance in the pension rescue plan are either employee contributions or assets that may be withdrawn by the employee as described above.

An example may be helpful. Assume that an IRA owner has a $5 million IRA. The IRA owner is 66 years old and his spouse is 65. The family also has a business or can form a business in which the IRA owner will be employed. The business will adopt a profit sharing plan. With the assistance of their professional planner, the family realizes that they need only $3 million of their IRA to fund their lifestyle expenses through retirement. They agree that they will never need $2 million of their IRA money and see the wisdom of purchasing life insurance with some or all of the excess $2 million in the IRA because they realize that the excess IRA may encounter double taxation. They also have $200,000 of non-IRA money that they are willing to use to meet their planning goals.

After rolling the excess $2 million from the IRA to the company-owned profit sharing plan, the profit sharing plan purchases a $6.4 million survivorship life insurance policy. The premiums are $200,000 per year for five years. The first four premiums are paid by the profit sharing plan. The client pays the fifth premium with after-tax money, after the policy has been distributed from the plan. In year four, at the time of distribution from the profit sharing plan, the policy will have a cash surrender value of $178,732.

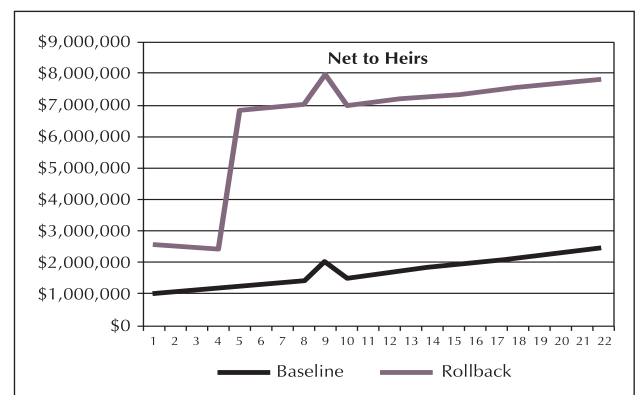
Assuming that the policy value is measured by the cash surrender value, distribution of the policy will generate a federal income tax of $49,809. Plans should be in place to gift or sell the policy to an ILIT or FLP at the interpolated terminal reserve value (ITR) after distribution from the plan to avoid estate taxation of the death benefit. In this example, the ITR in the fourth year is $1,184,000. Though beyond the scope of this article, additional tax management strategies may be available to reduce the transfer taxation on the transfer of the life insurance policy.

The total after tax benefit to the heirs at life expectancy[20] using the pension rescue plan is $7.7 million under these facts. Alternatively, the IRA, growing at six percent, after estate and income tax (and adjusting for the exemption equivalent used to transfer the policy out of the estate), transfers only $2.5 million to the children. Chart 8 compares the year-by-year results of the pension rescue plan as against the IRA left intact.

If the assets are invested more aggressively and generate a 10-percent net return on assets inside the IRA and nine percent on assets outside of the IRA, the heirs will receive $9.5 million from the pension rescue plan as against $5.3 million without it.

One final caution should be taken into account. Until the insurance policy has been rolled out of the plan and transferred out of the estate, significant tax liability remains. There are a number of ways to handle this risk, including term riders on the insurance contract or separate term policies purchased for the specific purpose of covering the risk of death before the insurance policy is out of harm's way. Although the income tax risk is eliminated upon roll out from the profit sharing plan, the estate tax risk may not be eliminated until three years after the insurance policy is transferred out of the estate.

Chart 8



The IRA/FLP Plan

The limited partnership is a valuable planning tool. Its value might be summed up in a word: versatility. Fortunately, professional planners are beginning to understand how to integrate the limited partnership with IRA planning.

The limited partnership has been around for a long time and was created to assist the capital markets around the turn of the century. At the time, the traditional C corporation was the principal means of raising capital. However, it was subject to the infamous "double taxation" (profits and dividends). As an alternative, the general partnership provided flow-though taxation, solving the double taxation problem of the C

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corporation. But the general partnership had its own flaw. The general partnership brought general liability to the investors.

The advent of the limited partnership solved both problems by offering flow-through taxation to all partners while also limiting the liability of the limited partners to their investment. Over the years, professional planners have learned how useful the limited partnership can be, especially for family wealth planning.

The family limited partnership (FLP) is nothing more than a limited partnership applied to family wealth planning objectives, such as:

- keeping capital together and providing a structure that allows long-term investment management of assets;
- protecting assets from the claims of the client's creditors, as well as the creditors of their children and grandchildren;[21]
- facilitating estate planning;
- preventing heirs from getting too much, too soon;
- providing a structure to keep the family unified and working together;
- deterring family contests with regard to inheritance rights;
- minimizing legal and court costs;
- reducing exposure to the legal system; and
- developing an ownership structure that permits flexibility and change.

Perhaps its most significant planning feature is the separation of ownership from control by virtue of the differing legal attributes of the general and limited partnership interests. The general partner can control the entire partnership with as little as one-percent ownership of the entire partnership. This feature provides significant planning opportunities. The FLP is especially valuable as a flexible gifting mechanism.

It is easy to see why professional planners would like to use FLPs with IRA assets, but for years, it was unclear whether an IRA could own an interest in an FLP. The issues that challenge the use of FLPs are similar to those limiting the use of closely held businesses. A number of articles have been written on the topic of IRA ownership of closely held business entities.[22] The IRS, in its qualified plan audit manual, also recognizes this concept.[23] In addition to these sources, case law and recent administrative opinions provide guidance for planners working in this area.

The chief concern with IRA ownership of FLP interests was whether such an investment and subsequent ownership would cause a prohibited transaction or raise self-dealing issues. The U.S. Tax Court in *J.H. Swanson*[24]; the IRS in FSA 200128011[25]; and the Department of Labor in *Advisory Opinion 2000-10A* each recognizes that it is possible for an IRA to invest in a closely held business entity without creating a prohibited transaction or self-dealing issue. Provided that care is taken to stay within the constraints of this legal authority and the rules governing IRAs, it is clear that an IRA owner may direct his IRA custodian to invest in an FLP without running afoul of the prohibited transaction and self-dealing rules.

Prohibited transactions can also result from ongoing management of the partnership. Although it is clear from the available authority that the initial formation of the FLP can be accomplished without causing a prohibited transaction, subsequent operation of the FLP could cause a problem.[26] For this reason, it is important to understand what can and cannot be done with a partnership owned by an IRA. For example, the client should not be paid for services rendered to the partnership, sell or lease assets to or from their partnership or enter into lending relationships with the partnership so long as the IRA owns the partnership.

Attention also should be paid to the so-called business purpose rule. The IRS has argued that a partnership formed solely to avoid taxation lacks a legitimate business purpose and should be ignored. If the IRS were successful with this argument, it is possible that significant tax savings associated with the FLP would be lost. This is a serious consideration, but one that should be readily handled with proper planning. Rarely is planning single-faceted; that is, all plans, especially in the larger and more complex cases, have multiple objectives that the planner must address with multiple and integrated solutions. As discussed earlier, the FLP has many positive and useful attributes. If it is used solely for tax purposes, it is probably being underutilized and possibly, misused.

As mentioned in the introduction, the focus of this article is on the taxation of large IRAs. FLPs have the potential of adding significant value as a tax-management tool as well. This benefit results from a negative adjustment to the value of the limited partnership units required by well established legal authority. This negative valuation adjustment, or valuation discount, results from a lack of marketability and control that limited partnership interests typically withhold from their owners.

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Interestingly, the loss of value can also decrease income and gift tax.

The decreased value caused by the FLP will decrease the minimum distributions of the IRA, and by extension, the income tax. For example, the minimum distribution factor for a 71-year-old is equal to 3.77 percent of the IRA account value. If the IRA account value is $5 million, the required minimum distribution would be $188,500. However, if the IRA were valued at $3.5 million, because of a valuation adjustment, the minimum distribution would decrease to $131,950. This would leave substantial assets in the IRA to continue to grow tax-deferred.[27]

The FLP could potentially reduce gift and estate tax as well. For example, the value of the IRA included in the taxable estate is the value of the limited partnership units held by the custodian. Assuming that those units have an adjusted value of $3.5 million, rather than the face value of the assets owned by the FLP of $5 million, the estate tax calculation would be as illustrated in Chart 9.

This compares favorably to our earlier example where the estate tax on a $5 million IRA is $2,046,900. The valuation adjustment of $1.5 million caused by the FLP translates into a tax savings in this example of $618,600. Should the client decide to roll out of the IRA in a single year, the valuation adjustment would reduce the lump sum tax from $1,139,897 to $799,676.

With the support of recent legal authority,[28] it should be expected that the planning community would see an increase in the use of FLPs with IRAs. However, as with all sophisticated planning tools, caution must be taken in formation and in operation, as the application of the FLP to IRA planning is still in its nascent stage.

Conclusion: Putting It All Together

Managing the tax consequences of a large IRA can be a challenge. With as much as 75 percent of the IRA potentially at risk to the combination of income and estate tax, something should be done. But just how to approach the large IRA can be confusing. More than the looming taxation however, the real danger may be the silver bullet claiming to solve the large IRA taxation problem. If such a strategy truly is focused singularly on tax avoidance, it is likely to be overly aggressive and susceptible to IRS attack.

Approaching the large IRA from a more balanced perspective will yield better and safer results.

Chart 9
Year of Death 2002

IRA	$3,500,000
Non-IRA Assets	$1,000,000
Estate Tax	$1,428,300

Viewing the IRA as one of many assets in the client's portfolio with which the professional planner can work to achieve the client's overall family wealth planning objectives is a healthier approach. When planning is approached in this manner, the various strategies chosen must work with each other as part of an integrated plan.

The strategies discussed in this article—the stretch unitrust, the charitable pension plan, the pension rescue plan and the family limited partnership—are integrated strategies. Each strategy solves tax, legal and financial problems while helping the family to reach a number of different objectives, and they each easily integrate with other planning strategies in the comprehensive plan.

To choose which strategies are the best fit, you may want to begin with the end in mind by first gathering a thorough understanding of both the client's circumstances and objectives. With this foundation well understood, the appropriate combination of strategies will become apparent.

ENDNOTES

* This article is reprinted with the authors' permission from J. Practicle Estate Planning, Oct.–Nov. 2002, at 39.

1 Aged 47 to 64.

2 Edward N. Wolff, Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire (2002).

3 *Id.*

4 *Id.*

5 *Id.*

6 Knute Iwaszko and Brian O'Connell, *The 401k Millionaire,* Sound Mind Investing, Sept. 2000.

7 Approximately 84 years in a majority of cases.

8 Account grows at eight percent. Minimum distributions start at 71.

9 Assumes that the participant waited until age 70 1/2 to begin his minimum distributions, and his investment portfolio grows at eight percent annually, throughout the minimum distribution period.

10 Federal only.

11 Assumptions: starting balance of $1 million; maximum federal income tax rate with no deductions or credits; maximum federal estate tax rate, no deductions or credits; no state income or death tax; assets in the IRA grow at seven percent; assets out of the IRA grow at six percent; no distributions are made from the IRA during the 10-year period.

12 For information about Crescendo Interactive, Inc., visit their Web site at *www.crescendointeractive.com*.

13 Reg. §1.643(b)-1. Definition of "income"—For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Code, the term income when not preceded by the words "taxable," "distributable net," "undistributed net" or "gross," means the amount of income of an estate or trust for the tax year determined under the terms of its governing instrument and applicable local law. Trust provisions that depart fundamentally from concepts of local law in the determination of what constitutes income are not

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recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of Code Sec. 642(b) (relating to the personal exemption) and Code Sec. 651 (relating to "simple" trusts).

[14] InsMark, Inc. of San Ramon, California provides illustration software to insurance and financial planning professionals that is designed to show complex concepts to clients accurately, but simply. Additional information can be found on their Web site at *www.insmark.com.*

[15] 5 U.S.C. §8432(j) provides that a conduit IRA is no longer necessary.

[16] The policy also could be purchased from the plan following the guidance contained in DOL Prohibited Transaction Exemption 77-7 (redesign Ted as 92-5) and 77-8 (redesignated as 92-6).

[17] Notice 89-25, 1989-1 CB 662.

[18] Rev. Rul. 69-408, 1969-2 CB 58.

[19] Rev. Rul. 60-83, 1960-1 CB 157; Rev. Rul. 54-231, 1969-2 CB 58.

[20] For purposes of the illustration, life expectancy is deemed to be 22 years. Assets in the IRA are deemed to grow at six percent and out of the IRA at five percent. All distributions are re-invested after the payment of income taxes. The policy interest rate is at five percent.

[21] Note that IRAs are not protected under federal law from the claims of creditors. However, in many states, IRAs are protected by state statute. This state protection was recently called into question in the matter of *D. Lampkins v. R.H. Golden*, CA-6, 2002-1 USTC ¶50,216, in which a state court judge allowed a creditor to reach a debtor's IRA, notwithstanding the existence of a state statute providing otherwise. This has given many financial professionals new reason to use limited partnerships to add a layer of creditor protection to IRAs.

[22] University of Southern California Tax Institute (2001), Book 2 at §1807.4; Andrew J. Willms, *Investing Individual Retirement Accounts in Family Limited Partnerships*, THE PRACTICAL TAX LAWYER, Winter 2001; Andrew J. Willms, *The Qualified Plan Insurance Partnership*, ALI-ABA ESTATE PLANNING COURSE MATERIALS JOURNAL, Oct. 1998.

[23] IRM 4.72.8, Employee Plans Technical Guidance, Valuation of Assets.

[24] *J.H. Swanson*, 106 TC 76, Dec. 51,155 (1996).

[25] FSA 200128011 (July 13, 2001).

[26] *But see Swanson, supra* note 26, where the taxpayer was the sole officer and director of the closely held entity and also the sole officer and director of a sister corporation owned by Swanson. The IRA corporations did all of its business with the sister corporation and did so in a way that would appear to have been prohibited by Code Sec. 4975. Yet this behavior did not raise the court's eyebrow.

[27] Note that the minimum distribution could be made in cash or in-kind. In many cases, an in-kind distribution will be preferable, since it is likely to help the client achieve his nontax goals.

[28] *Supra* notes 23, 24 and 25; DOL Advisory Opinion 2000-10A.

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