Insight on Estate Planning

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The Roth IRA: A powerful estate planning tool

A Roth IRA may not be the first thing you think of when considering estate planning techniques. After all, not only is it designed to be a retirement savings vehicle, but your income is likely too high for you to be eligible to contribute.

A change that goes into effect in 2010, however, may allow you to add a Roth IRA to your estate planning strategy. It can be a powerful tool for accumulating and preserving wealth for your heirs.

All taxpayers can now convert

If you have a significant balance in a traditional IRA — or in an employer plan that you intend to roll over into a traditional IRA — consider the potential benefits of a Roth IRA conversion. Once an option only for taxpayers with a modified adjusted gross income (MAGI) of $100,000 or less, starting in 2010 *conversions* are available to taxpayers at all income levels.

If you have a significant balance in a traditional IRA, consider the potential benefits of a Roth IRA conversion.

Bear in mind that higher-income taxpayers remain ineligible to make Roth IRA *contributions*. For 2010, contributions are phased out beginning at a MAGI of $167,000 for joint filers ($105,000 for singles and heads of households) and eliminated when MAGI is above $177,000 for joint filers ($120,000 for singles and heads of households).

No required distributions

One of the biggest advantages of a Roth IRA is that it's exempt from minimum distribution requirements, allowing the funds to continue growing tax free for many years. With a traditional IRA, you're required to start taking distributions on reaching age 70½ — regardless of whether you need the money — and those distributions are taxable at *ordinary* income tax rates, not the lower long-term capital gains rates.

With a Roth IRA, you can preserve more wealth for your family by leaving funds in the IRA for as long as possible. After you die, your heirs will be subject to the same distribution requirements that apply to all IRAs inherited by nonspouses. In most cases, they'll be able to stretch out distributions over their life expectancies and, as discussed below, qualified Roth IRA distributions are income tax free.

Tax-free withdrawals

Distributions of *contributions* to a Roth IRA can be withdrawn at any time tax free. Distributions of amounts rolled over to a Roth IRA at least five years prior are similarly tax free.

When a Roth IRA is at least five years old, qualified distributions of earnings — including distributions after age 59½ and for qualified first-time homebuyer expenses — are tax free. But that doesn't mean all Roth IRA distributions escape taxation altogether.

For instance, distributions of earnings before age 59½ that aren't qualified will be subject to both taxation and an early withdrawal penalty. And distributions that are free of income tax because they're done on or after attaining age 59½ may still be subject to an early withdrawal penalty in certain circumstances. There are specific ordering rules, so be sure to understand them before taking a distribution.

Income tax considerations

Unlike a traditional IRA, which is funded with pretax dollars, a Roth IRA is funded with after-tax dollars. In the case of a conversion, you're subject to taxes on the amount you convert as if you'd withdrawn the funds from the traditional IRA and reinvested them in a Roth IRA.

The difference is one of timing: With a Roth IRA you pay the taxes now; with a traditional IRA you pay the taxes when you withdraw the funds. So, which type of IRA creates more wealth?

From an income tax perspective, it depends on the relative tax rates. If your future tax rate turns out to be the same when the funds are withdrawn as it is now, it's a wash. If you expect your tax rate to be lower in retirement, a traditional IRA likely will produce a greater after-tax return. If you expect your tax rate to go up in retirement, a Roth IRA is generally preferable.

Estate tax savings

From an estate planning perspective, the Roth IRA is the clear winner. Assuming there's an estate tax (see the Estate Planning Pitfall on page 7 for information on the 2010 estate tax *repeal*), traditional IRAs are poor estate planning vehicles because their full value is included in your taxable estate even though your heirs are saddled with a sizable income tax liability on the distributions they receive.

Roth IRAs are also includible in your taxable estate, but the size of your estate is reduced by the amount of income taxes you pay on the

Roth IRAs for kids: The best of both worlds?

One of the best ways to provide for your children's (or grandchildren's) financial security is to encourage them to start saving at an early age. The power of compounding allows even a relatively modest investment to grow into a substantial nest egg by the time they reach retirement age.

For children who have summer or after-school jobs, a Roth IRA may offer the best of both worlds: Tax-free contributions *and* tax-free withdrawals. In 2010, children can contribute up to $5,000 or 100% of their *earned* income, whichever is less, to a Roth IRA. They can also earn income up to the standard deduction amount ($5,700 for 2010) tax free.

Suppose that in 2010 Mary, a high school student, earns $5,000 working after school and has no other income. She contributes all of her earnings to a Roth IRA. Because Mary's earnings are within the standard deduction amount, there's no income tax. And, because she invests her earnings in a Roth IRA, qualified distributions of all future contributions and earnings will be tax free.

Most kids aren't too keen on working without enjoying the fruits of their labor. But you can use annual exclusion gifts to replace some or all of the income they set aside for retirement.

conversion, and qualified distributions to your heirs are tax free. In other words, by paying income tax on amounts converted into a Roth IRA, you provide a benefit to your heirs by allowing them to receive future distributions tax free.

Unlike a traditional IRA, which is funded with pretax dollars, a Roth IRA is funded with after-tax dollars.

Whether this makes economic sense depends on several factors, including whether you'll have a taxable estate and whether your heirs will take advantage of the ability to defer their distributions over their lifetime.

Should you convert?

To determine whether a Roth IRA conversion is right for you, it's important to analyze all of the income and estate tax implications, including the tax consequences of the conversion itself. If your traditional IRA is large enough, for example, converting the entire balance in a single year might bump you into a higher tax bracket. Note that, for conversions in 2010 only, you can defer the tax and report half of the income on your 2011 return and half on your 2012 return.

If you decide to convert, it may be better to do so sooner rather than later. Converting now, while the value of many of your investments may be depressed, can minimize the income tax cost. ▮

Splitting the insurance bill

Family split-dollar arrangements can reduce gift taxes

Dave and Susan have established an irrevocable life insurance trust (ILIT) to purchase and hold a second-to-die life insurance policy, because they assume the estate tax will be in effect. (This article is written under the same assumption. See the Estate Planning Pitfall on page 7 for information on the 2010 estate tax *repeal*.) When the second spouse dies, the death benefit will be paid to the trust estate-tax free and then distributed tax free to their daughter, Anna, the trust's beneficiary.

There's just one problem: To cover the policy's $40,000 premium, Dave and Susan make annual contributions to the ILIT, which are considered taxable gifts to Anna. Because of the way the trust is structured, the couple can use their combined annual gift tax exclusions (currently, $26,000 per year) to shield a portion of each contribution from gift tax. But they're still stuck with a taxable gift of $14,000 per year. A family split-dollar insurance arrangement may be the answer.

The split-dollar solution

Dave and Susan's estate planning advisor suggests they consider a split-dollar insurance arrangement to reduce or possibly eliminate their gift tax liability. Under their arrangement, Dave and Susan will continue to make contributions to the ILIT equal to 100% of the premium amount.

When the second spouse dies, however, the insurance proceeds will be *split* between the spouse's estate and the ILIT. The policy's cash

surrender value (or the total amount of premiums paid, if greater) will go to the spouse's estate, while the ILIT will retain the rest for Anna's benefit.

If the split-dollar arrangement is designed properly, the gift tax value of Dave and Susan's contributions will be based on the "economic benefit" received by the ILIT. To determine the economic benefit, the IRS measures the current cost of life insurance according to IRS tables. Generally, this amount is only a fraction of the total premium.

Be aware that, even though this strategy reduces gift taxes, the sums that go to the second spouse's estate are potentially subject to estate tax, depending on the size of the estate and how much estate tax exemption is available. So the amounts repaid to the spouse's estate, as well as any estate tax liability they might generate, should be taken into account in determining the appropriate amount of insurance to purchase.

The split-dollar risks

Ordinarily, when you own an insurance policy on your own life, the insurance proceeds are included in your taxable estate when you die. By having a properly structured ILIT own the policy, you can keep the policy — as well as the death benefit — out of your estate, preserving more wealth for your family. To ensure this result, however, you must not retain any "incidents of ownership" in the policy, such as the right to change beneficiaries or borrow against its cash value.

In Dave and Susan's arrangement, there's a risk that the IRS will claim that, by retaining rights to the cash surrender value, they're the policy's owners for estate tax purposes. If that's the case, the entire amount of insurance proceeds could be brought back into the second spouse's estate and subject to estate tax. Part of the problem is that, for gift tax to be based on the economic benefit rules, Dave and Susan must be deemed the owners of the policy for purposes of the split-dollar regulations.

Last year, however, the IRS issued a private letter ruling (PLR 200910002) accepting an arrangement like the one described above. But PLRs have no precedential value, and facts and circumstances can vary greatly, so there's no guarantee that the IRS will accept similar arrangements in the future.

Split decisions

This split-dollar insurance example is just one of several types of split-dollar arrangements. There are other ways of splitting the costs and benefits of life insurance between you and your beneficiaries, including having beneficiaries pay a portion of the premiums. Your estate planning advisor can help you determine whether a split-dollar insurance arrangement would benefit you, which type of arrangement would be appropriate and whether the potential rewards justify the risk. ▮

I'll take a pass

Use a qualified disclaimer to forgo an interest in property

When it comes to estate planning, the more flexibility your plan affords, the better. Why? Estate planning isn't static — after you create your plan, life continues and your circumstances likely will change. Estate tax laws also might change, warranting different strategies. A qualified disclaimer is one estate planning tool that provides you some flexibility. Note that the disclaimer strategies discussed here assume the estate tax is in effect. For information on the 2010 estate tax *repeal*, see the Estate Planning Pitfall, opposite.

Defining a disclaimer

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. When you make a disclaimer, the disclaimed property is treated as if it had never been transferred to you. The property then passes according to the terms of the transferor's will or trust as if you had died before him or her — you don't get to choose whom the property will pass to.

If your disclaimer is "qualified," the property will be redirected without negative gift or estate tax consequences.

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Under the Internal Revenue Code, a disclaimer of an interest in property is qualified if it's in writing and is delivered to the transferor (or his or her representative) within nine months after the transfer is made or, if later, within nine months after the disclaimant turns age 21. In addition, the disclaimant must not have accepted the disclaimed property interest or any of its benefits.

A disclaimer in action

Let's say Jack and Janet have had successful careers and built substantial wealth, but they haven't implemented smart estate plans. As a result, most of their assets are either held jointly or in Jack's trust. After Janet's death, the jointly held property passes to Jack by operation of law. Regrettably, Janet's entire estate tax exemption is wasted.

A disclaimer can be the answer. By Jack disclaiming, Janet's half of the account will pass directly to their son, as though Jack had predeceased Janet. The family can benefit from Janet's estate tax exemption and, to the extent the transfer doesn't exceed her exemption, the transfer will be estate tax free.

For married couples in community property states, special care may be needed when considering disclaimers; check with your estate planning advisor.

In another example, let's say Carol, an 80-year-old widow, has an estate in excess of the estate tax exemption. She's been gifting regularly for years and is making arrangements to implement other wealth transfer strategies. Carol's only sibling, Julie, has never married and has no children. She hasn't created an estate plan; thus, on Julie's death, Carol stands to inherit everything.

To make up for Julie's lack of planning, Carol uses a disclaimer. By disclaiming her entire interest in Julie's estate, Carol causes Julie's net worth to pass directly to Carol's children rather than adding more taxable wealth to Carol's estate.

Disclaimers add flexibility

When creating your estate plan, be sure to include a degree of flexibility to account for life's changes. If you're in line to inherit a significant amount of assets but in your particular set of tax circumstances it's not in your best interest, consider using a disclaimer to pass the wealth on to another beneficiary. ▮

Estate Planning Pitfall

You haven't looked at your estate plan in light of estate tax law uncertainty

It's always a good idea to review your estate plan annually to make sure it's still meeting your goals. But an estate plan review is more critical than ever this year, because of estate tax law uncertainty.

The tax act signed into law in 2001 that reduced the top estate tax rate and increased the estate tax exemption over the last several years also repealed the estate tax — for 2010 only. Additionally, the 2001 act included a 2010 sunset provision, essentially leaving estate tax rates and exemptions to go back to levels prescribed by pre-2001 law in 2011 (top estate tax rate of 55%; $1 million estate tax exemption).

It was expected that Congress would repeal the repeal by the end of 2009, but that didn't happen. As of this writing, the temporary repeal is in effect, though it still appears likely Congress won't let it stand. Congress may even have acted by the time you're reading this. Some of the possible options that have been discussed include:

- Retaining the 2009 levels (top estate tax rate of 45%; $3.5 million estate tax exemption) for 2010 only (perhaps retroactive to Jan. 1), and then addressing 2011 later,
- Retaining the 2009 levels permanently,
- Setting different levels permanently, or
- Letting the estate tax remain in limbo until an omnibus tax reform bill is enacted.

Regardless of what happens, it's important to review your estate plan now and, if Congress hasn't yet taken action, again after it does. Otherwise, your estate plan may have unintended results. For example, your estate or heirs could incur unnecessary tax liability. Or one loved one could end up with a larger inheritance than you intended and another with a smaller one. Your estate planning advisor can provide you with the latest information and ideas for building flexibility into your estate plan.