Use Life Insurance Now to Prepare for Conversion to Roth IRA

Your client may be the owner of a traditional IRA and he is (or will be) required to take minimum distributions starting at age 70½ because the law requires that he do so. He is forced to pay income taxes at the time of distribution, as will his heirs because the IRA does not get a “step-up” in cost basis at his death.

Because of this, many owners of traditional IRAs would prefer to leave a Roth IRA to their families. A Roth IRA can be a valuable estate-planning tool because it can grow income tax-free and there is never any annual Required Minimum Distribution (“RMD”) even after the owner’s death. A Roth IRA accountholder is not ever required to take distributions. If distributions are made, they are received income tax-free. For these reasons, a Roth IRA is a better asset to inherit. The Roth IRA can be left to a beneficiary, who, similarly, will not be required to take distributions. All distributions the beneficiary does elect to take from the Roth IRA will be income tax-free.

<table>
<thead>
<tr>
<th>$1,500,000</th>
<th>$1,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>$3,274,312</td>
<td>$4,428,246</td>
</tr>
<tr>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>$10,057,127</td>
<td>$20,992,231</td>
</tr>
</tbody>
</table>

If a spouse inherits (or converts to) a Roth IRA she can name her children as beneficiaries to receive the remaining account balance at her death. As an example, at 5% assumed earnings, a $1.5 million Roth IRA inherited by a surviving 70 year old spouse will grow to approximately $3.2 million by the end of her life expectancy, and to over $10 million by the life expectancy of her daughter (assuming the daughter is age 61 at her mother’s death). These amounts would be $4.4 million and almost $21 million respectively if we assume a 7% investment rate.

However there are two barriers to converting a Traditional IRA to a Roth IRA:

- First, there is the current requirement that the taxpayer’s modified Adjusted Gross Income be less than $100,000 in the year of conversion.
- Second, income tax must be paid on the current value of the IRA.

Starting in 2010, converting a traditional IRA to a Roth IRA will be much easier because the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), beginning that year, removes the requirement that a taxpayer’s adjusted gross income be less than $100,000 in order to convert.

An insurance-funded estate planning strategy described below can efficiently convert a traditional IRA to a Roth IRA at the owner's death. If you are an IRA owner and you are insurable, the strategy can minimize the tax cost of conversion. If you have a surviving spouse as a beneficiary it works best because the IRA will be deducted from your estate under the marital deduction rules.
Consider a man, age 70, who owns a traditional IRA worth $1,500,000 that he does not need for retirement income. He sees the advantage of a Roth IRA for his spouse, children, and grandchildren. However he does not want to convert to a Roth IRA during his lifetime because of his reluctance to pay the $525,000 in income-tax (assumed 35% tax bracket) that is required as the cost of conversion.

If he is in reasonably good health, i.e. insurable, he can maintain the Traditional IRA, but use part of his Required Minimum Distribution to pay the premiums on a $525,000 life insurance policy on his life. Either he or his spouse can own the policy, and his spouse will be the beneficiary of the policy.

The RMD at age 70 is $54,744. The standard non-tobacco user premium for a $525,000 Whole Life policy is approximately $25,000 annually.¹

Any excess beyond the income tax on the distribution and the insurance premium can be spent, accumulated—or gifted to heirs. The heirs could even purchase additional life insurance with this gift, if they so desire.

At her husband’s death, his widow, as beneficiary, can rollover the IRA to her own name and then convert it to a Roth IRA immediately. She can use the life insurance proceeds to pay the income taxes. With the life insurance proceeds as a source of the income tax payment, she will not have to use any other cash, nor will she have to liquidate assets or take a distribution from the IRA itself to pay those taxes. The life insurance strategy thus overcomes the chief obstacle to conversion.

If there is no spouse, the non-spousal beneficiary(ies) of the IRA can purchase the life insurance on the IRA owner and accomplish the same result that would have been enjoyed by a surviving spouse. The beneficiary may still roll over the IRA and convert to a Roth IRA using the insurance proceeds. However, in this case, because there is no marital deduction, there may be estate tax owed on the value of the IRA.

The life insurance death benefit does not create any additional estate tax problems if a spouse is beneficiary of the IRA and the life insurance because the death benefit will qualify for the estate tax marital deduction when paid to his widow. When the proceeds are used to pay income taxes, the death benefit is removed from her estate. If children are the beneficiaries of both IRA and insurance it would be wise to also give them ownership of the life insurance in order to keep the proceeds out of the insured’s (i.e. the IRA owner’s) estate.

Naturally, the Roth IRA balance remains a part of the estate of any beneficiary (spouse or otherwise) eventually, just as the traditional IRA would also have been part of the taxable estate had the conversion not taken place. Hopefully the beneficiaries will effect a plan that will pay the anticipated estate taxes, if any, without invading the Roth IRA. However, even if funds from the Roth IRA must be distributed to pay estate taxes on the account, there will be no additional income taxes to pay as there would have been with a traditional IRA since Roth IRA distributions are income-tax-free.

So the simple purchase of permanent life insurance has the potential to help your clients enhance the value of their IRAs. This purchase can improve the financial life of their beneficiaries by funding the tax cost of converting to a Roth IRA, which eliminates the necessity to ever take Required Minimum Distributions from their IRAs and means that they can pass on a legacy to future generations, sheltered from income taxes.

Notes:
¹Guardian Whole Life 121 product
²Any reference to male gender is for convenience only; everything discussed applies equally to female IRA owner with male spouse