New Jersey Law Journal

VOL. CXCI – NO.4 – INDEX 286 JANUARY 28, 2008 ESTABLISHED 1878

IN PRACTICE

# ESTATE PLANNING

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## The Retirement Asset Swap

### Retirement account assets can be converted into life insurance that will pass tax free

Estate planners are confronted with unique challenges when developing strategies for clients to gift their IRA accounts and/or retirement plan accounts, such as pension, profit sharing and 401(k) plans. Because participants are unable to change the owner of these accounts, and withdrawals from IRA and retirement accounts result in income taxes and potential penalties, these assets are typically the last assets estate planners look at to reduce the estate tax value of a client's estate. This article examines a strategy that effectively converts retirement account assets — which would be subject to income and estate taxes — into life insurance that will pass income and estate tax free to a participant's beneficiaries.

Assume a client has a $1 million IRA, is in the highest income tax bracket and has a taxable estate. If the client does no planning with his IRA, the percentage of the IRA that will ultimately pass to the client's beneficiaries is approximately 30 percent. This is based on the fact that the IRA assets will be included in the client's taxable estate and subject to federal and state estate taxes at a rate of approximately 50 percent. The distributions that are made from the IRA to the client's beneficiaries also will be subject to income tax at a rate of approximately 40 percent (assuming the client resides in a state with a state income tax, such as New Jersey or New York). While the beneficiaries will receive an income tax deduction for the estate tax attributable to the IRA, the bottom line is that there will be a significant depletion of the IRA.

To avoid this depletion, the client can take an informal route to convert the assets to an income and estate tax-free asset (properly owned life insurance), or a more formal approach to do the same thing. The informal approach first begins with the IRA participant taking distributions annually penalty free after attaining age 59-1/2, and using the net after tax proceeds to gift to an irrevocable life insurance trust that will acquire, own and be the beneficiary of a $1 million life insurance policy on the client's life. The life insurance trust is structured in a manner such that annual gifts to the trust will qualify for the client's gift tax annual exclusion (currently $12,000 per year to any person), so long as the beneficiaries of the insurance trust have a present interest in the gifts. If the beneficiaries receive notice of their right to withdraw their pro-rata portion of the amount contributed by the client each year, the gift will qualify for the client's annual exclusion. Thus, there will no gift tax consequences in connection with the client's gifts to the irrevocable trust.

Generally speaking, life insurance is a favored asset for estate planning purposes because insurance proceeds can be kept out of the insured's estate. So long as the insured is not the owner of the policy and his estate is not the beneficiary of the policy on his life, the life insurance proceeds will not be taxed in his estate. For a married client, the insurance also will not be taxed in the surviving spouse's estate because the trust will be drafted in a manner so that the spouse technically will not have sufficient control to cause the assets to be included in the spouse's estate. Thus, the insurance proceeds will pass tax-free to the client's children.

Each year thereafter, the client will take a distribution from his IRA, and contribute the net after tax proceeds to the trust so that the trust can pay the premium on the $1 million policy. At the client's death, the insurance trust will collect the $1 million death benefit income and estate tax free and hold the proceeds for the benefit of the client's surviving spouse and other family members. The remaining IRA proceeds will pass to his beneficiaries after factoring in estate and income taxes.

Doing nothing, the client's family would receive approximately $300,000; by employing the swap strategy, the client passes $1 million of insurance proceeds to his family, plus the remaining balance of his IRA subject to taxes.

The more formal approach could be considered for clients who do not nec-

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essarily need their IRA or retirement accounts during their lives. Rather than the client self-annuitize his IRA, as is the case above, with a portion of the client's IRA, the client will invest all of his IRA in a single life insurance company annuity contract and use all of the net after-tax distributions from the single life annuity to gift to his irrevocable life insurance trust, which will acquire a life insurance policy on the client's life. The client's age and health will determine the amount of the annuity paid by the annuity contract and the amount of life insurance that can be acquired.

At the client's death, the IRA will have no value because it was invested in a single life annuity and pursuant to its terms, no more payments are made after the client's death, and the life insurance trust will collect on the policy it owns income and estate tax free. If the client passes away 18 months after implementing this strategy, while the single life annuity purchased in the IRA would have been a terrible investment, it is more than covered by the replacement insurance acquired by the client in the insurance trust, which turns out to be a terrific investment. Essentially, the IRA asset has been moved from one taxable pocket to another nontaxable pocket, suffering only the income tax on the annuity distributions while providing a significantly larger amount to the client's beneficiaries.

A married client can employ this strategy as well. Rather than purchase a single life annuity, the client would invest in an annuity contract, which pays until the last to die of the IRA owner and his spouse. The client would then take his after-tax annuity distributions and gift them to an irrevocable survivorship trust, which will acquire a life insurance policy on the lives of both the IRA owner and the IRA owner's spouse. This type of insurance pays a death benefit on the death of the second spouse and is typically much cheaper than a single-life policy because its pays off after the second spouse to die, and not the first. From an estate tax perspective, this type of insurance may be more worthwhile because it pays when the estate tax liability will be incurred (i.e., at the surviving spouse's death), and if properly owned in an irrevocable survivorship insurance trust, it will not be taxable in either estate, but the proceeds will be available to help pay for death taxes and administrative expenses.

At the IRA owner's death, the spouse can either continue to take distributions from the deceased spouse's IRA as an inherited IRA or rollover the IRA to his or her own IRA. In either case, the IRA would still be invested in the annuity contract, and the surviving spouse would continue taking the net after tax annuity distributions, and gift them to the survivorship life insurance trust to enable the trust to pay the premiums on the survivorship life insurance policy. At the death of the second spouse, the trust will collect the insurance proceeds income and estate tax free while the income and estate taxes payable in the IRA will be zero because the value of the IRA assets is zero.

There are a couple of points to consider. This strategy is not for every client. First, the client needs to be insurable in order to acquire insurance. Second, the client would need to dedicate a significant portion of his retirement assets during life to acquire the replacement life insurance, and the client may need the retirement asset to maintain his lifestyle. In this situation, while an all or nothing approach may not be warranted, to the extent the client can use any portion of the retirement asset to swap, it may be a worthwhile endeavor to explore. Finally, the client's other gifts and existing insurance need to be analyzed. If the client is otherwise using his annual exclusion gifts in connection with other assets, or has other life insurance, this strategy may need to be scaled down. In the case where the client is using his annual exclusions elsewhere, the client could use a portion of his $1 million lifetime gift exclusion to apply to the gifts to the insurance trust.

The toll of income tax and potential IRS penalties (for premature distributions) for IRAs and other retirement assets generally results in estate planners being very reluctant to recommend gifting strategies for them. Even after factoring in these traps, the retirement asset swap could be a strategy that could be very beneficial to a client's family. ■