



Estate Planning with IRAs: Estate Tax Repeal Did Not Repeal Tax for Everyone

Do you have prospects with significant savings in their qualified plans or IRAs? Many of these prospects believe that the legislation repealing the estate tax will enable them to pass these assets to their heirs without loss due to taxation. However, even during the one year of estate tax repeal, IRAs and qualified plans continue to be subject to income tax when distributed. Life insurance may be the appropriate solution to help replace dollars lost to taxation.

Facts: Assume your clients, both age 70, have an estate equal to \$3 million, consisting of mostly illiquid rental property and an IRA valued at \$1,000,000. The husband owns the IRA and has named his wife as the primary beneficiary. The clients indicate that they will not need the income from the IRA because the rental property provides more than what is needed to maintain their standard of living. They want to leave their entire estate to their children and grandchildren while minimizing loss caused by taxation.

The Problem: Although qualified plans and IRAs are generally the best way to accumulate dollars for retirement, they are not necessarily good vehicles for passing money to future generations. At death, these assets trigger tax and are known as “income in respect of a decedent” (IRD) assets. For income tax purposes IRD assets, unlike other assets, do not receive a step-up in basis at the death of the owner. Even during the one-year period of estate tax repeal, executors are not permitted to allocate the \$1.3 million limited step-up in basis to IRD assets.

So, when a participant dies with a qualified plan or IRA asset, it is included in their estate subject to estate tax. Then, in the year(s) it is distributed to the named beneficiary, it must be included in the recipient’s income for tax purposes and is taxed again. Even though the recipient beneficiary is allowed a deduction for the estate tax attributed to the amount received this “double tax” can reduce the value passing to the heirs by as much as 66%. Bottom line – estate tax repeal did not repeal taxes for individuals with large qualified plan or IRA balances.

Solution: One strategy is to stretch the income-tax-free growth of the qualified plan or IRA assets for as long as possible in order to substantially increase the income future generations will receive. This can be done by setting up separate accounts for each beneficiary. Younger beneficiaries (e.g., grandchildren, great-grandchildren) have longer life expectancies than adults, thereby lengthening the potential deferral period. Beneficiaries in low income-tax brackets will decrease the income-tax burden leaving more money for heirs. However, for this solution to work, there must be adequate funds to provide estate tax liquidity without using plan assets to pay estate taxes. The solution? Income-tax-free death benefit proceeds under IRC section 101(a) provided by a life insurance policy held in an irrevocable life insurance trust (ILIT). Death benefit proceeds in an ILIT can provide liquidity to pay estate taxes.

IRD assets, the source of the problem, can also provide a means to an end. Where the participants **definitely do not need the income** generated by the qualified plan or IRA, whether now or in the future, the after-tax distributions can be used to fund premium gifts to the ILIT. Using either the annual gift tax exclusion in conjunction with *Crummey* provisions, or using part of the gift tax applicable exclusion amount, will protect these gifts from being taxed. Often, where the spouse is the beneficiary, survivorship life is used to reduce the transfer tax costs attributed to the premium gifts. Care must always be exercised when using this option. As we have seen in recent years, a down stock market can radically change a client’s financial situation so that qualified plan assets really ARE needed to provide income. Consequently, a safer course may be to purchase needed life insurance using assets other than qualified plan assets.

Prudential offers a portfolio of life insurance products to help clients solve this problem.

SEE NEXT PAGE FOR IRD CALCULATION

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