

## **Planning Ideas—Three Strategies for Handling Income in Respect of a Decedent**

It is not uncommon to encounter affluent and high-net worth (HNW) clients with large amounts of Income in Respect of a Decedent (IRD). IRD refers to income streams payable to the decedent during his or her lifetime and continuing after death. Examples include survivor benefits associated with retirement assets, such as IRAs, qualified retirement plans (QRPs), and non-qualified annuities.

In most instances, wealthy clients will not be required to depend on these “retirement” assets for retirement income. Even after taking required minimum distributions (RMDs) into account, the assets may continue to increase in value until the owner’s death. A natural inclination is to designate children or grandchildren as the beneficiaries. Properly structured, this arrangement allows the assets to continue to grow tax-deferred with RMDs stretched out over the beneficiary’s lifetime.

The problem is that the value of the beneficiary’s interest is included in the account owner’s estate, exposed to federal estate tax and, if beneficiaries include heirs more than one generation removed from the owner, the generation-skipping transfer tax (GSTT). The estate tax is due, generally, within nine months of the account owner’s death, notwithstanding the fact that benefits may be payable over many years, potentially creating a liquidity crunch for the estate. To add insult to injury, because the survivor benefits are IRD, the beneficiaries must include the distributions in income as they are received.

Although estate and GST taxes are repealed for 2010, they are set to return in 2011 at the 2001 level. Back then, the exemption was only \$1 million per individual and the maximum rate was 55 percent. Not only that, the Bush tax cuts are set to expire in 2010. Beneficiaries could find themselves in a higher income tax bracket than the account owner.

The double whammy of estate and income taxes on IRD assets is ameliorated by a deduction against the beneficiary’s income for the amount of estate taxes attributable to the IRD. However, a deduction is not a credit and does not reduce the beneficiary’s income taxes dollar for dollar. In fact, if the beneficiary is in a 35 percent marginal income tax bracket, the deduction only saves 35 cents on the dollar in income taxes.

The result is that even with the income tax deduction, the total estate and income tax bite out of IRD could approach 60 percent.

## Example

Max Carter just turned 59. In addition to closely held businesses interests and other investments that place him in the highest estate tax bracket, Max has \$2 million in an IRA. His children are designated as beneficiaries of the survivor benefit. Even after taking RMDs into account, Max's advisor has estimated that the IRA balance will increase in value to \$3 million by Max's life expectancy. However, instead of receiving the entire \$3 million, as Max intended, his children are probably looking at only about \$1.8 million after estate and income taxes (assuming 2009 rates). The potential estate tax alone could be as high as \$1,350,000 (.45 times \$3 million), due and payable in cash within 9 months of Max's death.

Let's consider some strategies to minimize the tax bite.

### Strategy #1

One strategy is for Max to purchase life insurance to:

- (1) Provide liquidity to pay the estate taxes due nine months after death; and
- (2) Replace the income tax the IRA benefits are likely to attract as they are paid to his children. The death proceeds of the insurance are receivable income tax free by the beneficiaries. In addition, if the insurance is owned by and payable to a third party, such as an irrevocable life insurance trust (ILIT), the death proceeds escape inclusion on Max's estate.

The viability of this strategy hinges on Max's health. If Max is in good health, life insurance at standard or preferred rates is likely to make sense. If Max is in ill health and qualifies only for a *rated* policy, or is outright uninsurable, other alternatives should be considered. At a minimum, if Max is firm on having his children receive the IRA benefits, his investment portfolio should be liquid enough to reflect the cash call his estate will receive from the IRS in the event of death.

### Strategy #2

Another strategy involves Max engaging in a Roth IRA conversion and paying the income tax today on the IRA's current value of only \$2 million, instead of passing off the income tax on the estimated future IRA value of \$3 million to his children. This strategy is especially appealing in 2010, because Max can spread the income received on the conversion over both 2011 and 2012. Also, because Max is not required to take RMDs from a Roth IRA, the estimated value of the Roth IRA at his life expectancy will exceed the \$3 million estimate for the traditional IRA, all other things being equal.

To make this strategy work, Max needs to have either cash or near cash assets available to pay the current income tax. Furthermore, Max should wait until he turns 59 ½ to execute the Roth Conversion. Doing so beforehand could result in imposition of the 10 percent penalty tax associated with early IRA withdrawals.

### **Strategy #3**

This alternative involves naming a charity the beneficiary of Max's IRA. The survivor benefits paid to the charity escape both income and estate taxes.

The challenge with this strategy is that while Max's favorite charity benefits, his children lose out. A common approach to addressing this concern is to replace the value of the charitable gift, or some portion thereof, with life insurance. Again, the viability of this option depends on Max's health and arrangement of the life insurance policy so that it avoids inclusion in Max's estate for estate tax purposes.

### **Bottom Line**

Affluent and HNW clients need to consider the impact of large IRD assets. Failure to plan can lead to beneficiaries receiving less than expected and/or a cash crunch for the account owner's estate.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: [www.cannonfinancial.com](http://www.cannonfinancial.com).

Copyright ©2010 Cannon Financial Institute - All Rights Reserved

Subscribe to Cannon Insights at <http://www.cannonfinancial.com/newsletter/subscribe>

*Although Max is young enough that he doesn't need to worry about the impact of increased income due to the Roth Conversion of Social Security benefits and Medicare premiums, other clients need to watch out for this "tax trap."*

*In general, Social Security benefits are not subject to income tax. However, depending on how much other income an individual has, 50 to 85 percent of Social Security benefits may be included in gross income. How do you think even your wealthy clients feel about paying income taxes on Social Security benefits they've contributed to all their lives?*

*Not only that, increased income due to a Roth Conversion can result in higher premiums for Medicare Part B. With personal health insurance becoming increasingly expensive or unavailable to many, even wealthy clients may cringe at the idea of paying higher Medicare premiums due to a Roth Conversion.*

**Disclaimer:** The materials and information contained herein are intended for educational purposes, to stimulate thought and discussion so as to provide the reader with useful ideas in the area of wealth management planning. These materials and information do not constitute and should not be considered to be tax, accounting, investment, or legal advice regarding the use of any particular wealth management, estate planning, or other technique, device, or suggestion, nor any of the legal, accounting, tax, or other consequences associated with them.

While the content herein is based upon information believed to be reliable, no representation or warranty is given as to its accuracy or completeness. For this reason, the program of study should not be relied upon as such. Although effort has been made to ensure the accuracy of these materials, you should verify independently all statements made in the materials before applying them to your particular fact pattern with a client. You should also determine independently the legal, investment, accounting, tax, and other consequences of using any particular device, technique, or suggestions, and before using them in your own wealth management planning or with a client or prospect. Information, concepts, and opinions provided herein are subject to change without notice.

The strategies contained within these materials may not be suitable for all clients. For many concepts discussed herein, clients are strongly urged to consult with their own advisors regarding any potential strategy and will need to discuss their particular circumstances with their legal and tax advisors beforehand to determine whether a particular strategy described herein is suitable for their particular circumstances.

Examples, provided throughout these materials, are for illustrative purposes only, and no representation is being made that a client will or is likely to achieve the results shown. The examples shown are purely fictional and are not based upon any particular client's circumstances.