

IN THIS ISSUE: An Alternate to a Roth IRA Conversion?



The media and financial publications are constantly talking about conversion of traditional IRAs (Individual Retirement Accounts) to Roth IRAs starting in 2010. As a general rule, a Roth conversion may make sense for high net worth individuals who do not need the IRA account for retirement, and can afford to pay the income taxes from funds other than the IRA. In those situations, the Roth IRA may be viewed as a more efficient way to transfer wealth to children or other family members because of the income tax-free nature of withdrawals. Of course, to convert to a Roth IRA, distributions from the traditional IRA are taxable as ordinary income. *So, is there a better way to transfer this wealth and create this legacy?*

A Possible Solution: Keep the Traditional IRA and Purchase Life Insurance

Starting in 2010 every taxpayer who owns a traditional IRA has the option of converting to a Roth IRA. The obvious benefits of a Roth IRA are income tax-free withdrawals¹ by the taxpayer or the IRA beneficiary upon the taxpayer's death. Previously, high income earners were prohibited from utilizing this planning strategy because of income limitations but those limitations have been lifted. Individuals who convert in 2010 can elect to pay the income taxes that year or spread the taxes over the next two years. As a result of this income tax burden, the Roth conversion may be a planning strategy better suited for high income and high net worth individuals as a wealth transfer and legacy strategy.

However, there may be a better alternative to the Roth conversion that involves retaining the traditional IRA, and re-allocating the amount that otherwise would have been paid in income taxes upon the conversion to purchase life insurance.

To illustrate let's take the following example. Joe is 65 years old and has a \$1,000,000 traditional IRA he does not need for retirement. His accountant has recommended a Roth conversion that will generate an income tax liability of about \$400,000. The accountant also told Joe that the Roth IRA would indirectly save on estate taxes because his estate would be reduced by the

payment of income taxes. While true, technically, this is an expensive way to save on estate taxes. Joe may be better off retaining his traditional IRA and using the \$400,000 that otherwise would have been spent on income taxes and buying life insurance. Let's take a look at two simple insurance options.

Insurance Option 1

If Joe is more concerned about enhancing retirement income and less concerned about estate taxes, he could purchase a single premium life insurance policy. A \$400,000 single premium whole life policy on a male, age 65, assuming the second best underwriting class, may be enough to purchase upwards of \$700,000 of insurance, or more². At age 85, death benefits may be projected to be over \$1,241,000. This type of policy could be used for future retirement needs because of cash value growth. Even though the insurance policy will be deemed a modified endowment contract ("MEC")³, Joe only pays income taxes if he receives lifetime distributions from the policy when the cash values are higher than basis. Upon his death, Joe's designated beneficiaries will still receive the death benefit income tax-free, even if the policy is a MEC.

Insurance Option 2

If Joe is more concerned about estate planning and wealth transfer, he can retain the \$400,000 that otherwise would be spent in income taxes, invest it,

and simply use a portion of that each year to purchase life insurance on his life. For example, \$25,000 per year for 20 years (Joe’s approximate life expectancy) may be enough to purchase approximately \$1,200,000 of secondary guarantee universal life insurance⁴. This allows Joe to maximize the death benefit from the beginning. To further enhance Joe’s estate plan and wealth transfer strategy, the policy could be purchased and owned by one of Joe’s beneficiaries or an irrevocable trust. This will ensure that the death benefits of the life insurance policy are not included in Joe’s estate for estate tax calculation purposes.

The insurance policy options described above are dramatically different. The single premium policy illustrated in Option 1 will have a much lower initial death benefit that should grow based on the company’s ability to pay dividends that would be used to purchase paid-up additional insurance. The policy has guaranteed and non-guaranteed cash values that can be used for retirement. The universal life policy illustrated in Option 2 has a much higher initial guaranteed death benefit. However, the death benefit will not grow, and has no lifetime cash value benefit. Other types of insurance policy options are also available that may make more sense depending on the facts and circumstances of your situation.

CONCLUSION

- 1 You can avoid paying hefty sums of money to the IRS in the form of current income taxes;
- 2 You can increase your legacy to your beneficiaries by using life insurance that can easily be structured to avoid estate taxes;
- 3 You can keep your traditional IRA, and will only have to take required minimum distributions starting after you reach age 70 ½;
- 4 Your IRA beneficiaries have the option of establishing a “Stretch” or “Inherited IRA” so that distributions can be based over their life expectancies. This avoids the beneficiaries paying income taxes on a lump sum distribution; and
- 5 If you die prematurely, your beneficiaries receive the traditional IRA, the life insurance death proceeds, and the balance of the \$400,000 investment fund created to pay premiums, depending upon the insurance option.

Endnotes:

¹ Assumes that the individual has attained age 59 ½ and the individual had a Roth IRA account for at least five years starting from the first day of the taxable year in which a Roth contribution was first made, or if none, from the date of the first Roth conversion.

² This example is purely hypothetical and used for illustration purposes only. The amount of insurance that can be purchase will depend upon your own individual situation and underwriting circumstances.

³ A modified endowment contract is a life insurance policy that fails to meet certain tests. Distributions from MECs, including loans, are taxable as income to the extent the cash value in the contract exceeds the investment or cost basis in the contract. If the insured is under 59 ½ years of age, the gain portion of the withdrawal is subject to a 10% tax penalty.

⁴ Again, this is a purely hypothetical example and used for illustration purposes only.

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