



## 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 \$2.5 million dollars, consisting of mostly illiquid rental property and an IRA valued at \$500,000. The husband owns the IRA and the wife is named as primary beneficiary.

The client indicates 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. Assets in these plans 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 estate 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 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 structuring multiple accounts with various beneficiaries chosen to either lengthen deferral i.e. grandchildren, great-grandchildren or to reduce the income tax burden i.e. beneficiaries in low income-tax brackets. However, for this solution to work there must be funds to provide estate tax liquidity without withdrawing from the plan 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 (an ILIT). These death benefits are available to pay estate taxes.

On the other hand, IRD assets that are 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, either using the annual gift tax exclusion in conjunction with *Crummey* provisions or by allocating part of the applicable exclusion amount. Often, where the spouse is the IRD beneficiary, survivorship life is used to reduce the transfer tax costs attributed to the premium gifts. Of course, care must 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 such 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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## Income Tax on Income in Respect of a Decedent (IRD) for Qualified Plans/IRAs

### To Calculate The Income Tax On IRD, Follow These Steps:

- 1) Calculate the estate tax on the total taxable estate, including the qualified plans and IRAs.
- 2) Calculate the estate tax without the qualified plans and IRAs.
- 3) Deduct this difference from the qualified plan/IRA balance.
- 4) Calculate the income tax on the remainder.

### Estate of Last to Die Spouse

(Assumption: marital and credit shelter trusts have been established and funded properly to take full advantage of the applicable exemption amount)

\$ 500,000	IRA
<u>2,000,000</u>	Other Assets
\$2,500,000	Total Taxable Estate

#### With Qualified Plan/IRA Assets Death 2005

#### Without Qualified Plan/IRA Assets Death 2005

#### 1) Estate Calculations

Total Taxable Estate		\$2,500,000
Federal Estate Tax Before Credits	780,800	
Less: Applicable Credit	(555,800)	
Net Federal Estate Tax with Qualified Plans/IRAs		\$ 225,000

#### 2) Estate Calculations

Total Taxable Estate		\$2,000,000
Federal Estate Tax Before Credits	555,800	
Less: Applicable Credit	(555,800)	
Net Federal Estate Tax without Qualified Plans/IRAs		\$ 0

### Income Tax Calculations Where Qualified Plan/IRA is Subject to Estate Tax

3) Net Federal Estate Tax with Qualified Plans/IRAs	\$225,000
Less: Federal Estate Tax without Qualified Plans/IRAs	<u>0</u>
Federal Estate Tax attributed to Qualified Plans/IRAs	\$225,000

4) Total Qualified Plan/IRA Assets (IRD)	\$500,000
Less: Deduction for Estate Tax attributable to QPs/IRAs	<u>(225,000)<sup>1</sup></u>
IRD from QPs/IRAs subject to federal income tax	\$275,000
Assumed Income Tax Rate	35%

**Federal Income Tax due on IRD from QPs/IRAs \$96,250**

**Even after taking in consideration the IRD income tax deduction, the heirs will pay taxes of \$321,250 (225,000 + 96,250) a loss of approximately 65% of the IRA.**

<sup>1</sup> The deduction for estate tax attributable to QPs/IRAs is only available to individual taxpayers who itemize their deductions. Taken as a miscellaneous itemized deduction (not subject to the 2% adjusted gross income limitation) on Schedule A.