# The 75% Trap

## A strategy using FLPs and irrevocable trusts helps heirs avoid losing up to 75% of an inherited IRA's value to taxes. By Roccy DeFrancesco

DESPITE REGULATORY CHANGES, THERE is a simple but interesting way to reduce the income and estate taxes on qualified (deferred) money, both for IRAs and qualified plans. This two-part series on the 75% tax trap will also show how your clients can asset-protect their IRAs, reduce required minimum distributions, and in certain circumstances employ tax-deferred money to buy life insurance for estate planning purposes.

This kernel of the problem is what's known as "income in respect to decedent" (IRD). This includes any income an individual is entitled to but does not receive over his or her lifetime, such as IRA and pension plan account balances. The theory behind IRD is simple—the government doesn't want qualified or deferred money to pass on to a client's heirs without someone paying income tax on that money.

While most advisers create estate plans in order to avoid probate and large estate taxes, most forget to address the IRD problem. Therefore, there are tens of thousands of clients with estates bigger than $4 million and with $1 million or more in an IRA or qualified plan. And there are more people every day who have this problem as the baby boomers get closer to retirement.

For example, let's look at this client: Dr. Smith, age 60, married, two children and five grandchildren. Dr. Smith has a $6 million estate, $1 million of which is in an IRA. What would happen to Dr. Smith's IRA money if he died today? Absolutely nothing. In fact, Dr. Smith's IRA would pass to his spouse without income or estate taxes.

Assuming Dr. Smith had a revocable living trust and the estate tax exemption was $1 million, Mrs. Smith would be left with a $5 million estate (because $1 million would pass into Dr. Smith's trust and be removed from Mrs. Smith's estate). But what would happen to the IRA if Mrs. Smith died in the next few years? Mrs. Smith would still have a $5 million estate at her death (which would include the $1 million IRA), and the IRA would pass to her heirs, at which time income and estate taxes would be levied against it.

Let's take a look at the math:

IRA: ....................................$1,000,000
Estate tax: .......................... ($500,000)
Assets after estate taxes: ........$500,000
Income taxes:
  Federal (after deducting
  federal portion of estate taxes
  (35%)): ..............................($217,525)
  State (5%): ..........................($31,075)
Total taxes: ..........................($748,600)
Total IRA assets
  after taxes: ..........................$251,400

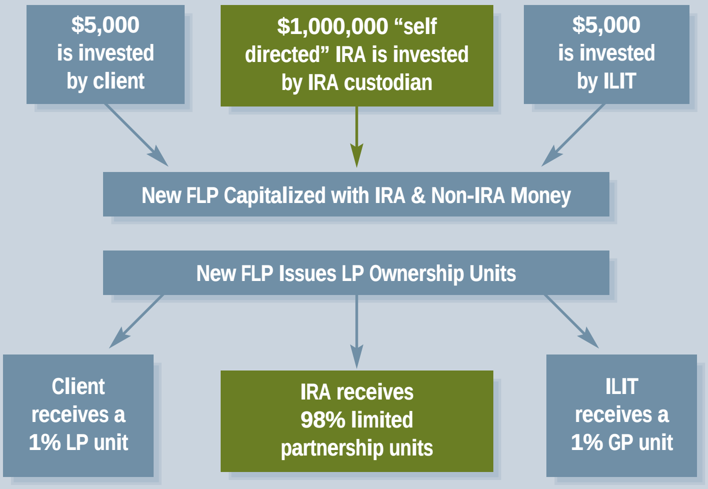
So Dr. Smith's heirs actually would receive only $251,400 of the $1 million IRA. Almost 75% of the account value would be lost to taxes. (This amount may vary depending on state income taxes.)

Most often clients receive no advice other than to spend down the money in the IRA so that it doesn't get double taxed when a client dies. Often advisers will tell a client who doesn't need the IRA money to give the IRA to a charity at his or her death. If the IRA is gifted during the lifetime of the client, income taxes are due. Giving the IRA asset to a charity certainly will relieve the client of income and estate taxes; however, the client's heirs get nothing from the IRA.

Many advisers will suggest that a client start taking distributions from the IRA, pay tax on those distributions, and

## Perfect Together

To avoid the 75% tax trap on inherited IRAs, the IRA, an irrevocable life insurance trust (ILIT). and the individual client form a family limited partnership (FLP).




give the amount remaining after tax to an irrevocable life insurance trust, which would, in turn, buy life insurance to pay for the estate and income taxes that will be due when the IRA is transferred to the heirs at the client's death. This can work, but clients would probably prefer to find a way to mitigate the taxes owed, not simply pay full taxes on distributions and then use that money to pay for the remaining estate taxes.

Recently, "stretch IRAs" have been discussed as one viable option. Stretch IRAs lengthen the time over which distributions must be taken from retirement plans or rollover IRAs. The common belief underlying this strategy is that tax-deferred growth is always a fabulous idea. When you crunch the numbers, however, you will realize that the stretch IRA is generally a bad idea for anyone who will have an estate tax liability (although a good idea for those who don't have estate tax problems).

Why? Because when a stretch IRA passes to a client's heirs, estate taxes are due. If a client passed on a $1 million stretch IRA to heirs, $500,000 in estate taxes would be due. Where are the children going to get $500,000 to pay the estate taxes? They will take money from the IRA. When the children take money from the IRA to pay the estate taxes, income taxes will be due on that money.

This creates a vicious cycle. To avoid it, consider this strategy: A maxi-IRA (a fancy name for a self-directed IRA) uses a family limited partnership (FLP) and an irrevocable life insurance trust (ILIT) to mitigate the 75% tax dilemma.

Few planners know that IRAs can purchase an interest in an FLP. There are a number of technical rules to follow that are outside the scope of this material, but based on *Swanson v. the Commissioner* (Feb. 14, 1996), FSA 2001-28011, and DOL 2000-10A, there is solid footing for this strategy. Very simply, the maxi-IRA, irrevocable trust (usually an ILIT), and the individual client form an FLP. (See "Perfect Together" above for a description of how this works.)

The maxi-IRA must own more than 50% of the partnership. The irrevocable trust is the general partner of the FLP. Each partner must make a nominal capitalization of the FLP in exchange for its interest in the FLP. The ILIT would then have the sole authority to manage the partnership assets as the managing general partner.

What does this scenario accomplish? If the FLP is set up correctly with the proper restrictions, the FLP interests could be discounted up to 20%. Why is this important? Because then the value of the assets inside the maxi-IRA gets deflated by 20%.

Let's look at the math again:

IRA: ..................The new value of the IRA assets after a 20% discount on the FLP interest is $800,000
Estate tax: ...........................($400,000)
Assets after estate taxes: ........$400,000
Income taxes:
Federal (after deducting the federal portion of estate taxes): .....($174,020)
State: ................................($24,860)
Total taxes: .........................($598,880)
Total assets after tax: ............$201,120

In this case, the client still paid 75% in tax. But while the value of the FLP for tax purposes was discounted by 20%, the real value to the owners of the FLP interest remains $1 million.

Remember, the maxi-IRA contains stocks or mutual funds worth $1 million. The maxi-IRA purchased an FLP interest that for valuation purposes received a 20% discount. When the client dies, the discounted FLP interest transfers to the heirs, and because of the discount, the heirs pay $598,880 in income and estate taxes instead of $748,600 in income and estate taxes. In short, the above scenario saves $149,720 in overall taxes.

And what about life insurance? Many clients with the 75% tax dilemma often still need or want to buy life insurance to use in their estate plans. The problem with any life insurance purchase is that it's almost always carried out using post-tax money by gifting money to an ILIT. With the maxi-IRA, clients can still have life insurance purchased by and owned by an ILIT in a tax-favorable manner. Here's how it works:

- The FLP (which is 98% owned by the maxi-IRA) is authorized to invest in an insurance policy that insures the life of the client.
- The partnership is designated as the beneficiary of the life policy.
- The general partner (the ILIT) contributes that amount toward the purchase of the insurance contract that is equal to the Table 1 rates—the current term costs for death benefit coverage.
- The balance of the premium, which comes from the IRA, is then paid by the limited partner.

■ Upon the death of the insured, the IRA's interest in the partnership equals its investment plus a specified rate of return, typically simple interest at the long-term applicable federal rates.

■ The balance of the insurance proceeds is then distributed to the general partner—the ILIT—and, in turn, from the ILIT to its beneficiaries, free from income and estate tax.

Let's see how using a life insurance policy in the Dr. Smith situation would be beneficial. Remember that he has a $5 million estate that's growing rapidly. Dr. Smith took the advice of competent counsel and used his funds in his maxi-IRA to fund an FLP. Dr. Smith still has an estate tax problem, so he buys a life insurance policy owned by an ILIT, thus allowing the death benefit to pass income and estate tax free to the heirs. Dr. Smith is advised to purchase $2.5 million in death benefits to cover the 50% estate tax on a $5 million estate.

If Dr. Smith is healthy, it will cost him $55,000 a year for a "guaranteed" $2.5 million death benefit. If he's in the 40% tax bracket, it will cost him $91,666 in income to pay that $55,000 premium. That's quite painful. However, in the maxi-IRA, Dr. Smith's FLP (which was mainly funded with IRA money) has $1 million of tax-deferred income that can be used to buy life insurance, where the death benefit will pass free from both income and estate tax to heirs through the ILIT. (See "Alive or Dead" at right for a description of how this works.)

## Alive or Dead

In the maxi-IRA, Dr. Smith's FLP (which was mainly funded with IRA money) uses $1 million of tax-deferred income to purchase life insurance, where the death benefit will pass free from income and estate tax to his heirs through the ILIT.

**WHAT HAPPENS EVERY YEAR WHILE DR. SMITH IS ALIVE:**

**FLP**
**Funded with $1,000,000, loans $55,000 a year to the ILIT for premiums. The FLP will receive in return (at Dr. Smith's death) $55,000 plus interest calculated at simple interest at the long-term AFR rate.**

$55,000 premium is gifted to the ILIT.

**ILIT**
**Pays $55,000 a year for a $2,500,000 death benefit (with an increasing death benefit to cover the repayment of the loan (plus interest) from the FLP).**

**WHAT HAPPENS IF DR. SMITH DIES AT AGE 75:**

**FLP**
**If the $1,000,000 grew at 5.5% each year, there would still be $1,000,000 in the FLP after loaning $55,000 to the ILIT every year. Plus the FLP has an additional $882,750 as repayment for the ILIT loan.**

ILIT repays $882,750 for loan.

**ILIT**
**$882,750 will be paid to the FLP to repay the loan (plus interest) and $2,500,000 via a death benefit will pass income and estate tax free to the heirs of Dr. Smith.**

$1,882,750 maxi-IRA is transferred to the heirs (which is taxable).

ILIT pays $2,500,000 to heirs income and estate tax free.

**HEIRS**
**Receive $2,500,000 income and estate tax free from the ILIT. The heirs also receive the $1,882,750 interest in the FLP from the IRA (at a 20% discount for estate tax purposes).**

Note: Remember that the IRA owns the FLP interest, and as such, 98% of the income generated is not taxed at the time it's earned.

Now let's compare this strategy to a do-nothing example. Assume that Dr. Smith is 60 years old. If he dies when he is 75 years old, the $1 million IRA (with an assumed growth rate of 5.5% annually) would have $2.232 million in it. After paying all of the income and estate taxes, the heirs would receive $561,244.

If Dr. Smith used the maxi-IRA strategy, his heirs would receive $2.5 million income and estate tax free via death benefit from the ILIT and about $473,324 from the IRA after all taxes are paid.

Here's a look at the math:

IRA ($1,000,000 + interest from loan to ILIT): ........................$1,882,750
Estate tax: ...........................($941,375)
Assets after estate taxes: ........$941,375
Income taxes:
Federal (after deducting federal portion of estate taxes):...($409,545)
State: .................................($58,506)
Total taxes: .........................$1,409,426
Total assets after tax:..............$473,324
Total assets to the heirs with no planning:.......................$561,244
Total assets to the heirs with the Maxi-IRA: .................$2,973,324
Additional benefit to heirs using the Maxi-IRA: .......$2,412,080

As illustrated by the numbers above, the heirs would gain $2.4 million by having Dr. Smith implement the maxi-IRA solution. While this strategy may not yet be widely known, once it's introduced to your clients, there's little doubt that it will garner significant interest.

In the next article, I will discuss how the maxi-IRA solution can be executed inside a profit sharing or defined benefit plan. I will also address how the maxi-IRA asset-protects the value of an IRA and how required minimum distributions can be reduced. **FP**

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