Converting a Tax-Inefficient Asset into Twice the Legacy

Jeff and Lillian Grant, high school sweethearts, have been married for 50 years. Together, they raised five children, all while building a successful family business and giving back to their church and local community. As they prospered, their charitable gifts and charitable intent have become a passion they share. Now 70 and 68, respectively, they're transitioning the business to their children and looking forward to retirement, enjoying their nine grandchildren's activities and becoming even more active in their church and community charitable organizations.

Having achieved their American dream, Jeff and Lillian are comfortable financially. They have an IRA worth $10 million that they don't need for retirement income. Having seen that their children are financially secure, including using their lifetime gift exemptions as part of the installment sale of the family business to their children, they have two remaining legacies they want to secure: their grandchildren's and a charitable legacy for their community.

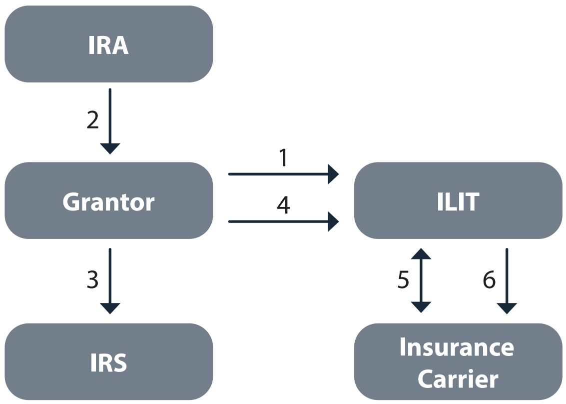
Jeff and Lillian planned on leaving their IRA for the benefit of their grandchildren, unaware of the impact several potential taxes could have on those assets. Their financial advisor explains that IRAs with significant account balances could see a reduction in value, due to taxes, of 70 – 85 percent of the IRA balance. She suggests that they use the IRA to accomplish both of their remaining legacy objectives:

1. **Replace the Value of the Tax-Inefficient IRA for Grandchildren –** Use some of their after-tax required minimum distributions (RMDs) to fund the premiums on a tax-efficient $10 million survivorship life insurance death benefit owned by an irrevocable life insurance trust (ILIT) for the benefit of their grandchildren.
2. **Leave a Significant Charitable Legacy –** By leaving the IRA and any reinvested RMDs to their desired charitable organizations, their estate would receive a full estate tax deduction for the charitable bequest. Additionally, the charity does not report "income in respect of a decedent" (IRD), thus eliminating both estate and income taxes on the IRA.

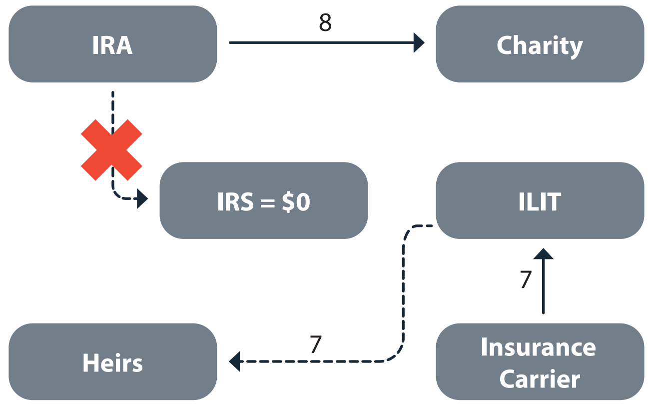
HOW IT WORKS

The IRA owner takes income from the IRA by taking the required withdrawals. Income tax is paid on the withdrawals and after-tax proceeds are then gifted to an ILIT to fund a life insurance policy. The ILIT will receive a tax-free death benefit upon the death of the insured(s). The IRA is left to charity upon the owner's death.

Now:



In the Future:



1. Grantor creates an ILIT.
2. Grantor receives distributions from IRA.
3. Grantor pays income taxes on IRA distributions.
4. Grantor gifts after-tax proceeds to ILIT.
5. ILIT applies for life insurance on the life of the grantor(s).
6. ILIT pays annual premiums to insurance carrier.
7. At death of the insured(s), ILIT receives life insurance death benefit estate and income tax-free for the benefit of heirs, replacing the value of the IRA.
8. IRA is left to charity, eliminating estate and income taxes on the account value.

The following chart shows the potential impact of the proposed plan on Jeff and Lillian's legacy.

ASSUMPTIONS:

1. $10 Million IRA
2. 4% Growth
3. Income Tax Rate – 39.6%
4. NIIT – 3.8%
5. Estate Tax Rate – 40%
6. $131,372 Annual Premium
7. 9 Annual Exclusions
8. Joint Life Expectancy (JLE) – 26 Years

VALUES AT JLE (YEAR 26)	DO NOTHING	IRA TO CHARITY AND REPLACE WITH LIFE INSURANCE
IRA	$4,687,678	$4,687,678
Reinvested RMDs	$10,995,540	$6,309,150
Death Benefit	$0	$10,000,000
Estate & Income Taxes	$(7,387,079)	$0
Net to Grandchildren	$8,296,138	$10,000,000
Net to Charity	$0	$10,996,828
Total Legacy	**$8,296,138**	**$20,996,828**
Percentage Increase Over Current Plan		153.09%

Their advisor also explains that while inherited IRAs aren't given the same creditor protections as traditional IRAs, an ILIT can provide creditor protection for beneficiaries. Additionally, an ILIT could allow distributions to beneficiaries over their lifetime or a set term of years, subject to the terms of the trust, which would mirror the IRA stretch. Excited about the potential to increase their desired legacies, Jeff and Lillian decide to proceed with their financial advisor's recommendation.

THE BOTTOM LINE

If Jeff and Lillian had continued with their original plan to leave their IRA and reinvested RMDs to their grandchildren, the total projected after-tax inheritance to heirs at joint life expectancy (JLE) was $8.3 million. By using some of their RMDs to purchase a $10 million survivorship death benefit to replace the value of the IRA for their grandchildren, they could leave their IRA and reinvested RMDs projected at $11 million at JLE to charity, increasing their total projected legacy to $21 million. Jeff and Lillian were able to convert a tax-inefficient IRA into a significant charitable legacy. And, by purchasing life insurance inside an ILIT with after-tax RMDs, they may be able to provide a larger after-tax inheritance and more flexible benefit to their grandchildren, while insulating the assets from creditors.