A Tax-Free Future

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The repeal of the $100,000 adjusted gross income (AGI) eligibility limit to convert from a taxable IRA to a Roth IRA served as a landmark event for high-income taxpayers who want the perpetual tax-free income streams that a Roth IRA can provide.

More clients in their 60s or 70s with large IRA balances will be looking to convert and for ways to finance the payment of large income taxes due upon the conversion.

Is there a method where a Roth IRA conversion can be financed that will allow clients to achieve this dream of unlimited tax free income for their family over an extended period of time? The answer is yes, and life insurance provides the key to unlock this golden door to a tax-free future.

Basic Roth IRA Conversion Rules in 2010 and Beyond

For those who converted in 2010 only, 50 percent of the income on the conversion could have been reported in 2011, and the other 50 percent of the income could have been reported in 2012. For those who convert in 2011 and beyond, 100 percent of the tax is due in the same tax year the conversion takes place. Part or all of a traditional IRA may be converted to a Roth IRA.

Step by Step Procedure for a Married Couple to Achieve Conversion to a Tax-Free Roth IRA

1 IRA owner names spouse as IRA beneficiary. Owner must take required minimum distributions (RMD) from the IRA upon reaching age 70½ until death.

2 IRA owner buys a no-lapse Universal Life (UL) policy on his/her life and names the spouse as the beneficiary. If desired, the IRA owner may allocate any after-tax RMD for premium payments.

3 At IRA owner's death, the surviving spouse first executes an IRA to IRA spousal rollover. This rollover is accomplished with no tax consequences.

4 Then, the surviving spouse converts all or part of the spousal rollover IRA to a Roth IRA. The spouse names the children/ grandchildren, or trusts for their benefit, as beneficiary of the new Roth IRA account(s).

5 Spouse receives the life insurance death proceeds income tax free. The proceeds paid to the spouse qualify for the federal estate tax marital deduction

6 Spouse uses all or part of the taxfree insurance death proceeds to pay the income taxes on the Roth IRA conversion.

7 Spouse is now the owner of a Roth IRA and, if needed, may take income tax-free distributions from the account. There are no RMDs required from the Roth IRA for the remaining lifetime of the spouse.

8 At the spouse's death, the balance in the Roth IRA is included in the gross estate. Of course, with proper planning while both spouses were alive, a no-lapse, survivorship universal life (SUL) survivorship policy owned by an irrevocable life insurance trust (ILIT) could be purchased and allocated to pay any second death estate taxes.

9 The beneficiaries of the Roth IRA (children, grandchildren or trusts for their benefit) have two distribution choices to receive the "inherited Roth IRA." The first choice is the so-called five-year rule – that is, the Roth IRA account must be completely distributed within five years of death of the Roth IRA owner. The second choice is the "life expectancy rule" – the account can be paid out annually over the life expectancy of the beneficiary if required minimum

distributions (RMD) start no later than Dec. 31 of the year following the death of the Roth IRA owner. Where a trust is the beneficiary of the Roth IRA, the trust beneficiary with the shortest life expectancy will be the measuring life for RMD distributions to the trust.

The Three Phases of IRA and Roth IRA Account Management

Phase 1 Curing lifetime of IRA owner, required minimum distributions (RMD) are distributed according to the Uniform Distribution Table

Phase 2 At death of IRA owner, surviving spouse completes the Roth IRA conversion process (see above) using the life insurance proceeds to pay income taxes due upon the conversion. No RMD from the Roth IRA is required for the remaining lifetime of the spouse.

Phase 3 Roth IRA beneficiaries receive income-tax free distributions either according to the “five-year rule” or the “life expectancy rule.” If the life expectancy method is chosen, the Single Life Table will determine the length of the RMD payout based on the life expectancy of the beneficiary. Children could easily have a life expectancy of 25 to 40 years and grandchildren could easily have a life expectancy of 50 to 70 years depending on the facts of the case. One hundred percent of the “inherited Roth IRA” required minimum distributions (RMD) over that extended time period will be income-tax free!

The tax-free financial leverage of using life insurance to finance the Roth IRA conversion plan will enhance the net after-tax inheritance for your client's heirs.

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