

Rescuing Pension Rescue Plans

Dealing with the IRD Problem is More Difficult, but Still Workable

By James E. Harris, CFP, and Michael B. Allmon, CPA

The December 2003 California CPA article on the hidden tax traps of income in respect of decedent (IRD) noted that the IRS clobbers certain types of assets, such as qualified retirement plans and IRAs at death.

For clients in the maximum income tax and estate tax brackets, the asset erosion due to taxation is severe, especially if qualified plan balances and IRAs pass directly to the client's children or grandchildren in a lump sum. In a worst-case scenario, the tax approaches 80 percent.

The article featured capital transfer strategies, sometimes known as IRA or

to buy the policy directly from the plan for its cash surrender value.

If distributed, the policy's value for income and gift tax purposes also would be its cash surrender value.

Because of the nature of policies used in IRA and pension rescue schemes, cash values as a percentage of total premiums paid have been very low in the early years of these types of contracts.

So, upon distribution or sale of the policies, relatively little income or gift tax occurred. The policies soaked up the majority of plan assets with minimal tax consequence. Policies that were too obvious in their approach were dis-

as the aggregate of (1) the premiums paid from the date of issue through the date of distribution, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends and similar income items, minus (3) reasonable mortality charges and other charges (other than mortality charges), but only if those charges are actually charged on or before the date of distribution."

In plain English, this means the entire cash accumulation value in a life insurance policy must be used as the interim safe harbor amount, which will be regarded as a policy's fair market value.

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pension rescue programs, as one method to solve the IRD taxation dilemma.

Pension Rescue Programs

For clients who were at or near retirement, with large estates and plenty of nonqualified retirement income, the approach was to use plan assets to purchase large life insurance policies, which ended up inside an irrevocable life insurance trust (ILIT), thus exempt from income tax and estate tax.

The strategy usually involved the following:

1. IRAs and IRA rollovers would be rolled into a new profit-sharing plan;
2. The profit-sharing plan would purchase a life insurance contract, preferably a second-to-die policy, and pay for that policy in one to five annual premiums coming from plan assets; and
3. Before policy cash values became too large, the policy would be distributed to the plan participant and ultimately gifted to his ILIT, or the ILIT would be pre-funded with enough cash

allowed as abusive in IRS Notice 89-25, but the life insurance industry created contracts to appear to be in compliance and the IRS seemed to look the other way for 15 years.

As of Feb. 13, 2004, the IRS released Rev. Proc. 2004-16, which provided interim guidance on "Life Insurance Valuation When Distributed from a Qualified Plan" and dealt a fatal blow to pension rescue techniques.

What the IRS Said

In a clarification of the regulations under Sec. 402(a) and Notice 89-25, the IRS said Fair Market Value must be used to determine valuation of life insurance contracts for purposes of transfers or sales of a policy from a qualified plan to a plan participant or policy beneficiary. The IRS said the guidance was intended to shut down abusive transactions that involve specially designed life insurance policies in retirement plans.

For now, "Fair Market Value shall be cash surrender value (without reduction for surrender charges) provided that the cash value is at least as large

What the Ruling Means

How does this impact IRA and pension rescue programs, and what is an alternative technique to offer clients which does not challenge any current or proposed IRS regulations? Here's an example:

Tom, 70, and Elizabeth, 62, are worth \$9 million. They have a \$1.5 million home, \$4 million in municipal bonds, a six-unit apartment building worth \$2 million, and Tom's \$1.5 million IRA rollover.

They have after-tax retirement income of \$265,000 per year and living expenses of \$60,000 per year. Their house and the apartment building are paid off, and they have no debt. There is no more depreciation on their commercial building and they are in a combined federal and state income tax bracket of 40 percent. They are also in the maximum estate tax bracket. They have done no advanced estate planning, but have a living trust.

Tom must start taking required minimum distributions from his IRA this year even though he and Elizabeth



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don't need the additional income. He would prefer giving this money to his three children and four grandchildren after he and Elizabeth die.

Prior to Feb. 13, Tom was set to do an IRA rescue program and form a small business for future real estate transactions. He was about to roll his IRA rollover into a new profit-sharing plan from his new business venture.

The profit-sharing trust was going to purchase a \$6.1 million second-to-die life insurance policy on Tom and Elizabeth. Although Tom had a heart attack a few years ago, he is insurable at Table 4. Elizabeth is healthy and qualifies for a preferred rate.

He was going to have his profit-sharing trust pay two payments of \$750,000 for two consecutive years. At the end of year two, he was going to distribute the life insurance policy out of his plan, pay income tax on the cash surrender value and file a gift tax return when he gifted the policy to an ILIT, which he was about to create.

Before Feb. 13, the numbers looked like this:

Cash Surrender at End of Year 2:	\$469,702
Income Tax:	\$187,881
Gift Tax Return:	\$193,777
	against credit

After Feb. 13, using Safe Harbor, the numbers are:

Accumulation Value at End of Year 2:	\$1,404,302
Income Tax:	\$561,721
Actual Gift Tax Paid:	\$162,385

Due to the increased taxes (from \$187,881 to \$724,106), Tom backed off from the whole transaction until another, more conservative approach could be found.

Another Rescue Plan

Here's an alternative Tom's advisers suggested: Take gradual, annual IRA distributions, pay all applicable income taxes and pay annual life insurance premiums with the after-tax amount.

The idea is simple, conservative, and provides more control of IRA assets, offers flexibility and follows IRS regulations.

Tom assumes that he can average an 8 percent return on his IRA assets. He takes a distribution of \$166,666 per year,

pays income tax of \$66,666, and creates a net after-tax distribution of \$100,000 per year for 16 years, and a final after-tax distribution of \$55,007 in year 17.

This way, he is able to get \$1,655,007 into the life insurance policy over a 17-year period, from an original amount of \$1.5 million in the IRA. The amount of coverage purchased is \$5,734,365, slightly less than the pension rescue amount, but more manageable.

This alternative provides Tom with more control and flexibility if he needs to stop funding the program at some point. With the pension rescue plan, the money is unrecoverable after year two.

Lastly, as compared to doing nothing other than taking required minimum distributions and ultimately bequeathing the IRA to his children at the second death, this is better for the heirs, even if Tom never spends his RMDs, but just accumulates them for the benefit of his children.

In year one of our comparison, his \$1.5 million IRA is worth \$486,788 after income and estate taxes if he and his wife die in that year. This compares with more than \$5.7 million going to his heirs using life insurance.

Even if Tom lives to 100, and averages an 8 percent return on his IRA, he'll never equal the life insurance amount. In that scenario, at 100, Tom's children would receive \$3,390,611 after all taxes, which is 41 percent less than his heirs would receive from the life insurance proceeds.

The choice is obvious between double taxation and guaranteed life insurance not subject to income and estate taxes, which is a very attractive proposition. The only question to ask is whether or not the qualified plan assets or IRA is needed for retirement income.

If the answer is no, then this technique can provide an effective solution to double taxation of retirement assets. ■

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