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Life Insurance and Roth IRAs: The Dynamic Duo

Summary

Clients who face income from minimum distributions on qualified plans and IRAs – but do not need that income – can benefit from a conversion to a Roth IRA. In addition, life insurance death benefit can give the surviving spouse the ability to convert a deceased spouse's qualified plan or IRA to a Roth IRA after death.

Related Information

Life Insurance in a Qualified Plan *in depth*

Background

The Roth IRA is an individual retirement plan that is covered by many of the same rules that apply to traditional IRAs, such as tax-deferred growth and post-death required minimum distributions.[1]

But there are differences. Unlike with traditional IRAs, contributions to Roth IRAs are made after-tax. While that might sound bad for Roth IRAs, they do not have to make any minimum distributions while the owner is alive (permitting more tax-deferred growth),[2] and once distributions are made from the Roth, they are often received *entirely income tax free*.[3] For these reasons, the Roth IRA can be a powerful tool to assist clients who want to maximize the amount they leave to heirs.

Roth IRAs can be created in a couple ways.

1. Contributions. Like the traditional IRA, a Roth IRA can be established as an individual retirement account or an individual retirement annuity.[4] This involves the taxpayer going to a bank, insurance company, or other IRA provider and setting up a Roth IRA account to which the taxpayer makes contributions.[5] Unfortunately, this ability to contribute to a Roth phases out as incomes get higher: in 2013, it phases out completely at modified adjusted

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[1] § 408A(a).
[2] § 408A(c)(5). Beneficiaries of a Roth IRA are required to take minimum distributions from the account after the death of the owner. Treas. Reg. § 1.408A-6, Q&A-14(b). However, a surviving spouse who opts to treat the Roth IRA as the surviving spouse's own Roth IRA is treated as the owner of the Roth IRA and is not required to take minimum distributions during the surviving spouse's lifetime. Treas. Reg. § 1.408A-2, Q&A-4.
[3] If certain requirements are met (e.g., generally that the Roth be held for 5 years and the owner is over age 59½). See §§ 408A(c)(1) and 408A(d)(1).
[4] §§ 408A(b) and 7701(a)(37).
[5] Treas. Reg. § 1.408A-2, Q&A-2.

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gross above $127,000 for those filing as single, and above $188,000 for those married filing jointly; in 2014, those income levels increase to $129,000 and $191,000.

2. Conversions. Luckily for those with incomes above those thresholds, establishing and contributing after-tax dollars to a Roth IRA isn't the only way to get money into one. A Roth IRA may be created when a taxpayer converts to a Roth IRA from an IRA (traditional, SEP or SIMPLE), qualified plan, 403(a), 403(b), or 457(b) plan.[6] This process is generally known as a Roth IRA conversion.[7]

   A Roth IRA conversion is treated as a distribution from the traditional IRA and a contribution to the Roth IRA. The distribution is taxed at the taxpayer's marginal rate for the year of the conversion, but generally is not subject to the 10% early withdrawal penalty.[8] If the taxpayer had made non-deductible contributions to the traditional IRA, these are not included in the taxable amount, along with any other amounts that constitute a return of the taxpayer's basis.[9]

   > *Example*: Ronald converts his traditional IRA, which has a $10,000 balance, to a Roth IRA in 2013. The traditional IRA does not contain any non-deductible contributions. Ronald will have to include $10,000 in taxable income in 2013 and, assuming a 25% federal income tax rate, will increase his tax by $2,500.

Getting Roth IRAs to nonspouse beneficiaries – qualified plans *v*. traditional IRAs

Many people who have traditional IRAs and qualified plans have income from other sources, so don't need these accounts for themselves. For these people, the idea of passing a *Roth IRA* to heirs such as children and grandchildren[10] is particularly attractive, as not only could the distributions be spread over the beneficiaries' lifespans, but the distributions would be income tax-free as well.

1. Convert while alive. One way to create a Roth for children is to carry out the conversion while still alive. As long as the owner has the wherewithal to pay the income tax, this should be no problem. He can then hold the resulting Roth IRA until death, and this is what the beneficiary will receive. There'll be required minimum distributions from the Roth that the beneficiary can stretch over his life, but those distributions generally won't be income taxed.

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[6] Beginning January 1, 2008, plan participants were permitted to convert amounts from a qualified plan, 403(a), 403(b) or an eligible government plan under 457(b) directly to a Roth IRA. Notice 2008-30, 2008-12 I.R.B. 638. This is assuming, of course, that the plan participant is eligible for a distribution from the plan.

[7] Any taxpayer may convert to a Roth IRA, regardless of income level or filing status. § 408A(c)(3)(B), *as amended by* P.L. 109-222.

[8] Treas. Reg. § 1.408A-4, Q&A-7(a) and (b).

[9] *Id*. When calculating the amount of a taxpayer's basis and taxable income, all non-Roth IRAs (traditional, SEP and SIMPLE) owned by the taxpayer must be combined. This is commonly known as the IRA aggregation rule of § 408(d)(2), and it prevents taxpayers from reporting no tax when, for example, they convert an IRA that contains only basis and leave alone another IRA that contains only gain. Notice 87-16 confirms that SEP IRAs and rollover IRAs are aggregated with traditional IRAs, and the Instructions to Form 8606 confirm the same for SIMPLE IRAs.

[10] Of course, any transfer to grandchildren should take the generation skipping tax into consideration.

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2. Convert after death – qualified plan yes; IRA no. But what about the IRA or qualified plan owner who doesn't have the means or desire to pay the income tax while alive? To figure out the options here, it is important to recognize a big – and frankly nonsensical – difference in the options available to those inheriting qualified plans versus IRAs:

    a. when a child (or any non-spouse) is the beneficiary of a *qualified plan*, he *can* convert it to a Roth IRA, but

    b. when a child (or any non-spouse) is the beneficiary of an *IRA*, he seemingly *cannot* convert it to a Roth IRA.[11]

Life insurance makes it all easier

For those who can't or won't convert to a Roth IRA while alive, converting after death is the way to go. This is where life insurance comes in. The income tax-free death proceeds received by beneficiaries make it easier for them to pay the income tax that's triggered by an after-death conversion to a Roth.

1. Qualified plan – life insurance proceeds to child is fine. If a married couple holds a qualified plan, and is sure to keep it in a qualified plan until death, then a second-to-die policy payable to a child or grandchild can provide that beneficiary with the funds to pay the tax. The same is true for an unmarried individual holding a qualified plan until death; a single life policy payable to the beneficiary of the qualified plan would do the job.

2. IRA – life insurance proceeds should go to *surviving spouse*. But if a married couple holds only an IRA – perhaps because they rolled their qualified plans to IRAs after retiring – their child or grandchild wouldn't be able to convert to a Roth. They would have to do the conversion when at least one of them is alive. So, a married couple should generally buy two single life policies, one on each spouse.[12]

[11] At least this is the safest interpretation of somewhat vague and circuitous guidance. Section 408A(c)(6)(A) and Treasury Regulation § 1.408A-4, Q&A-1(a) state that only amounts that meet the definition of a "qualified rollover contribution" can be converted to a Roth IRA. Section 408A(e) defines a "qualified rollover contribution" as including those coming from an IRA, but only if that rollover meets the requirements of § 408(d)(3), and this section states that a rollover *cannot come from an inherited IRA*. This prohibition apparently isn't sidestepped by the fact that the nonspouse beneficiary would be doing a trustee-to-trustee transfer rather than a 60-day rollover, as the Treasury Regulation dealing with Roth conversions treats those techniques as one and the same. See Treas. Reg. § 1.408A-4, Q&A-1(a), (c). As for nonspouses inheriting *qualified plans*, the Roth conversion option is available because the definition of "qualified rollover contribution" in 408A(e) that applies to qualified plans refers not to § 408(d)(3), but to § 402(c), and this section doesn't prohibit rollovers of inherited qualified plans. This ability to convert inherited qualified plans to inherited Roth IRAs was also confirmed by Notice 2008-30, Q&A-7.

[12] Due to the fact that transfers between U.S. citizen spouses generally trigger no income tax or transfer tax, it generally doesn't matter if the IRA owner holds the policy on himself and names the other spouse as beneficiary, or if the spouse of the insured IRA owner holds the policy and names herself as beneficiary.

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Advanced Planning Ideas

Example – stretch planning with traditional IRA v. converted Roth IRA[13]

Bill and Jane, both age 63, have $1,500,000 in Traditional IRAs (Bill has $1,000,000 and Jane has $500,000). Because of other sources of wealth, they don't need their IRAs to live on, and so intend to withdraw only the minimum required by law. This means that, starting at age 70½, they will be forced to receive income they will not need.

Bill names Jane as the beneficiary of his Traditional IRA and Jane names Bill as the beneficiary of her Traditional IRA. Both name their seven year old grandchild as the contingent beneficiary of their respective IRAs.

1. Traditional IRA

   Let's suppose that Bill dies 20 years later, at age 83, when his IRA balance is projected to be $1,414,000 and Jane's is projected to be $707,000 after having grown at a constant 5%. Jane rolls Bill's IRA into her own (a so-called "spousal rollover") creating an IRA with a balance of $2,121,000. She continues to take required minimum distributions,[14] but passes away five years later at age 88. After that, Bill and Jane's grandchild will begin to take minimum distributions from the Traditional IRA using his remaining life expectancy (he's age 32 when Jane dies, and let's assume he lives to age 83).[15] All of this results in total after-tax distributions for Bill, Jane, and their grandchild of $5,600,000.

2. Converting to Roth IRA after first death

   What if Jane rolls over Bill's IRA, but shortly thereafter converts the combined balance of her and Bill's IRA into a Roth IRA? This would mean that there'd be no required distributions until after her death, and distributions to her grandchild over his lifespan would be income tax free. Of course, she'd have to pay a chunk of income tax upon the conversion.

   To ensure that she has cash to pay the income tax, let's assume that, when Bill is age 63, Jane purchases a life insurance policy on him with a $600,000 death benefit.[16] The annual premium is $18,315, which she pays for by taking money out of her IRA. After Bill dies 20 years later and Jane rolls over his IRA, the combined IRA balance is $1,825,000 (this is

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[13] Keep in mind that stretch planning with IRAs – having the owner and beneficiary take only the required minimums distributions – makes sense when these parties have other funds to live on. This article's "Bill and Jane example" assumes they have such other funds, and also assumes the following: both are age 63 today, Bill dies 20 years later at age 83, Jane dies five years after that at age 88, and then the IRA is taken over by their then age 32 grandchild, who takes only required minimum distributions for another 51 years, until his age 83. We're also assuming all accounts grow at a constant rate of 5% (but this is not indicative of any specific investment, and all investments are subject to market risks and a potential loss of principal). Lastly, this example presumes no changes in tax law and ignores inflation, but taxpayers who are genuinely thinking of doing stretch planning should consider possible changes to tax laws, the impact of inflation, and other risks.

[14] Treas. Reg. § 1.408-8, Q&A-5(a).

[15] Treas. Reg. § 1.401(a)(9)-5, Q&A-5(c)(1).

[16] Again, because no one knows who will die first, it's likely wise to buy two single life policies, one on each spouse. We use only one policy here to keep the example easy. Buying two policies would generally mean a smaller IRA balance (there'd be more withdrawals to pay the extra premium), a resulting smaller income tax on the conversion of the smaller IRA, but more income tax free death benefit after the death of the surviving spouse (Jane).

lower than the projected $2,121,000 amount mentioned above, because here Jane is taking distributions from her IRA to pay the life insurance premiums).

Jane then converts this $1,825,000 amount to a Roth IRA. The income tax due upon conversion at an assumed 30% tax rate is $547,500.[17] The $600,000 of income tax free insurance proceeds will be sufficient to pay the taxes.[18]

What's the result? Presuming that the beneficiary of the Roth IRA is their grandchild – again, he's age 32 when he takes it over and lives until age 83 – the total amount of after-tax distributions from the Roth IRA will be $8,400,000.

This means that converting to the Roth after Bill's death results in an increase of almost $2,000,000 of overall net income for Bill, Jane, and their grandchild.

Life insurance on Bill accomplishes two goals: (1) it lets Jane maintain the other assets for her future use, reducing the chances that she will need to tap into the IRA, and (2) the insurance proceeds can pay the income taxes due upon converting, again avoiding use of the Roth IRA during her life, meaning her grandchild will inherit more. Jane maximizes the benefits of tax free compounding with this approach because she – and only she – pays the income tax on the current IRA balance once and never again.

Conclusion

The bottom line is that the cash created by life insurance is a cost effective way to maximize tax deferral and preservation of an IRA. With careful planning, income taxes can be minimized and deferred, while estate and GST taxes can be paid in a cost efficient way. And best of all, wealth is preserved for generations.

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[17] Transfers to U.S. citizen surviving spouses generally trigger no federal estate tax, as they enjoy an unlimited marital deduction. § 2056. If Bill and Jane are concerned about federal or state estate taxes, they must consider that when determining the appropriate amount of life insurance to preserve their IRAs.

[18] Jane may consider buying a larger life insurance policy to provide enough cash in the event the IRA investment returns or income tax rates exceed those assumed here.

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