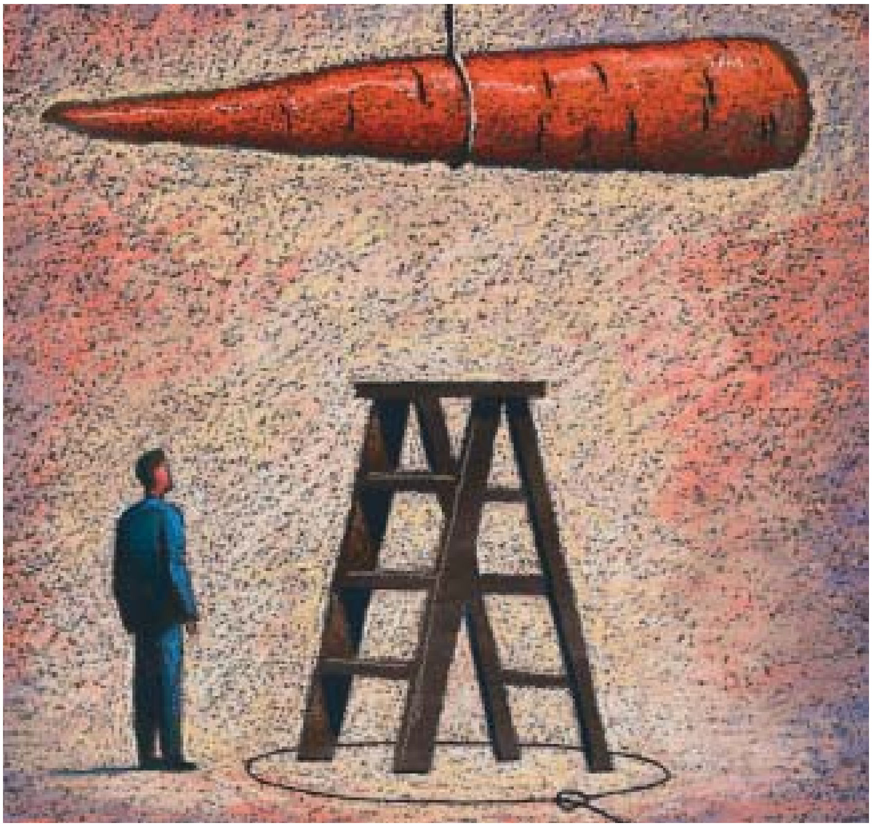
Springing the Trap

Here are some additional strategies advisers can use to help clients reduce taxes on inherited retirement money. **By Roccy DeFrancesco**



LAST MONTH, I EXPLAINED HOW ADVISERS could use a maxi-IRA strategy to help clients mitigate the 75% tax on money in inherited IRAs. The IRA purchases a majority interest in a family limited partnership (FLP), which in turn loans money to an irrevocable life insurance trust (ILIT), which then buys life insurance for estate planning purpose. The beneficiaries of clients with a maxi-IRA are better off than those who do nothing, since the strategy allows a big death benefit to pass income- and estate-tax free to beneficiaries, funded with what is effectively tax-deferred money.

The second part of this article will discuss how the maxi-IRA can be used as an effective asset protection tool. It will also address what strategies advisers can take to lessen the 75% tax trap when money is in a qualified retirement plan (profit-sharing or defined benefit plan).

Clients (and their advisers) may not be aware that 27 states (plus the District of Columbia) don't provide full asset protection for IRAs. These states are Arkansas, California, Connecticut, Delaware, Hawaii, Iowa, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hamp- New Mexico, North Carolina, North Dakota, Ohio, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming.

Many clients (especially professional clients like physicians, CPAs, attorneys, and financial planners) are concerned about asset protection. For clients who live in the previously mentioned states, using a maxi-IRA is a good way to asset protect the value in an IRA.

So how does a maxi-IRA help with asset protection? The short answer to this question is that the FLP limits a creditor's remedy to a "charging order." (For more on asset protection in general and how charging orders work, see "Protective Devices," September 2004, and "The Prevent Defense," August 2004).

If a creditor obtains a charging order against the FLP, what happens next? The creditor can't force the liquidation of the FLP or force a distribution, can't obtain an interest in the FLP, and can't direct how the money in the FLP will be used. In short, all the creditor can do is sit around and wait for a distribution to be made from the FLP. If such a distribution is never made, then the creditor will receive nothing.

Actually, the creditor might receive-something from the FLP—a K-1 form for phantom income. IRS Rev. Ruling 77-137 says that if a creditor has a charging order against an FLP or limited liability company (LLC) and if the FLP or LLC creates but does not distribute income, the creditor will in fact receive a K-1 for that income (income the creditor never received).

Therefore, when IRA money that was used to capitalize the FLP creates investment income, the creditor will get the K-1 for that income, even though it stays in the FLP. Obviously, no creditor is going to get a charging order against an FLP that generates income under these circumstances.

If your client is paranoid about asset protection and doesn't want to leave it up to the U.S. judges to grant a charging order as the sole remedy against the FLP interest, you could use an offshore LLC instead. In this case, the remedy is still a charging order, but the creditor must file suit offshore to get it (an expensive option). The creditor must go offshore because a U.S. court has no jurisdiction when dealing with an offshore LLC.

While the maxi-IRA is fairly simple to implement due to the relaxed rules on investments in IRAs, qualified plans are another story. Both profit-sharing plans and defined benefit plans may not invest in closely held stock or any FLPs in which an employee has an interest. Therefore, the FLP/ILIT solution used in the maxi-IRA won't work in a company's qualified plan.

A client can have a profit-sharing or defined benefit plan buy insurance as an investment, but in this case the death benefit will be subject to estate tax and partially taxed for income tax purposes. As a result, buying life insurance inside a profit-sharing or defined benefit plan for estate planning purposes is only a marginally useful strategy for clients.

A subtrust is an interesting concept created to keep life insurance purchased in a defined benefit plan out of a client's estate for estate tax purposes. The subtrust concept isn't simple to explain, so this article will only cover the basics of how it works. The subtrust generally is based on the same principles that allow ILITs to avoid estate tax when passing a death benefit to beneficiaries.

When an employer or an employee funds a qualified plan, mentally they see the money in the plan as their money. In reality, however, all qualified retirement plans are really funded through trusts that own the assets and administer them through the plan documents. There typically is also a third-party administrator and a plan trustee. If life insurance is purchased inside a qualified plan, it's done with the approval of the plan trustee and is owned by the trust itself, not by the employer or employees.

This may seem like just a matter of semantics, but it is not. With a typical ILIT, a client who funded the life insurance owned by the ILIIT can't have any "incidents of ownership" of the life policy, otherwise the trust itself is not irrevocable and the death benefit won't pass estate-tax free to the beneficiaries.

The premise is similar with a subtrust. If the trust or subtrust inside of a qualified plan has a trustee who isn't the insured participant, the death benefit should pass estate tax-free to the beneficiaries. Again, the rationale behind the life insurance being excluded from the participant employee's estate is that when the employee dies, he or she has no incidents of ownership of the life insurance policy (which is owned by a subtrust controlled by an independent trustee). Note that if the owner of the company is also the trustee of the qualified plan, a "special" trustee is needed to prevent the owner from controlling the life insurance policy in the subtrust.

So if the employee dies with the policy still in the subtrust, the death benefit should pass income- and estate-tax free to the beneficiaries (just like an ILIT). If the employee is still alive, the policy stays in the subtrust until the employee leaves (or until the plan is amended to no longer allow for life insurance). Before terminating employment, the employee would need to have a strategy in place to get the policy out of the plan. The most common strategy is for someone to purchase the policy.

A subtrust is designed to keep the life insurance purchased in a profit-sharing or defined benefit plan out of a client's estate for estate tax purposes.

Who can buy the life policy from the plan? Potential purchases include the insured participant and the employee's spouse, children, or other relatives. This scenario is really where the "pension rescue" life policy came from. Prior to the new regulations on 412(i) plans proposed recently, qualified plans could buy a life insurance policy, which after the fifth year would have a cash surrender value equal to 20% of the premium paid. At the end of the fifth year, the participant or employee would then purchase the policy at an 80% discount and gift it to an ILIT.

Unfortunately, the proposed 412(i) regulations state that the premium paid will be the fair market value of the policy instead of the cash surrender value. While the regulations make no sense (because they don't take into account surrender charges), they make getting a life policy out of a qualified plan more difficult (or painful due to the increased value of the policy).

There is also the question of whether the creation of a subtrust creates gift tax consequences. The answer depends on what kind of qualified plan is involved.

In a defined benefit (DB) plan, the employer/trustee of the DB plan is making the decision to purchase life insurance within a subtrust. If a special trustee buys a new life insurance policy in the subtrust, there should be no real gift tax issues to worry about.

In a defined contribution (DC) plan, on the other hand, the investments are directed by the plan participant. If that's the case, then there are gift issues to worry about when creating a subtrust. Barring the use of a split-dollar approach, there is no way to avoid gift tax consequences when creating a subtrust inside a DC plan. Since most clients don't want to pay gift taxes to establish and use a subtrust, the subtrust approach is almost never used in DC plans.

As with any DB or DC plans, the law says qualified plans can't discriminate in favor of highly compensated employees. So if a subtrust is used inside a qualified plan, the arrangement must be available to all participants.

If you have clients with money in DB plans who are looking for a way to buy death benefits via a life policy in a tax favorable manner and have those benefits pass income- and estate-tax free to heirs, you should consider researching the subtrust strategy. For more detailed information on subtrusts, please e-mail me and I will send you the technical summary on the topic. **FP**

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