



Tax Efficient Transfers of Qualified Accounts

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If your clients are anything like ours, they are usually quite shocked to learn that not only will withdrawals from IRAs, 401(k)s, and other similar tax deferred accounts (“Qualified Accounts”) be taxable as ordinary income, but, in addition, the full fair market value of these accounts are includible in their gross estate at death. The shock often times turns into a full blown catatonic state when it is further explained that in worst case scenarios, the net estate/income tax effect can result in their beneficiaries receiving as little as approximately twenty-five percent of the account when the client dies. This increasingly common scenario poses the obvious question: what strategies do we provide the client to limit or even eliminate the estate/income tax diminution of passing Qualified Accounts through a taxable estate?

One of the easiest & most cost effective solutions requires posing two critical questions. First, does the client require the Qualified Account to pay for current living expenses or is the intention to maximize the amount passing to the beneficiaries (i.e., is this a “live-on” or “leave-on” asset)? The second question: is the client in good health? Assuming the client is in good health, and the Qualified Account is a leave-on asset, then a reasonable solution is to establish an irrevocable trust to own a life insurance policy on the client’s life, and annuitize the Qualified Account, contributing the after income tax proceeds of the annual withdrawals to the trustee of the irrevocable trust to pay the premiums. Ideally, the death benefit of the life insurance would equal the beginning value of the Qualified Account. Also recommended is a life insurance policy that could be paid in full and an annuity period sufficient to reduce the value of the

Qualified Account to zero well before the expected death of the client.

The benefits of the transaction are clear. First, the value of the client’s estate has been reduced by the entire value of the Qualified Account eliminating the estate tax that would have been due. Second, the trust, and subsequently the beneficiaries, will receive the gross value of the Qualified Account in the form of income and estate tax free life insurance proceeds. Third, the client has the opportunity to impose restrictions, limitations and conditions on distributions from the trust through the terms of the trust document not otherwise available through the beneficiary designation of the Qualified Account. Of course, no transaction comes without cost. Foremost, there is the cost of establishing and maintaining the irrevocable trust and the psychological hurdle of irretrievably transferring money to a trust over which the client has no control. There is also the income tax cost of annuitizing the Qualified Account over a period shorter than the client’s life expectancy. Put in context, the income tax cost is at best minimal and only a difference in timing.

While the Qualified Account annuitization technique may not be appropriate for all clients, it certainly has its place given the right set of circumstances. Structured properly the financial benefits of the transaction far outweigh its costs, and as a legal advisor, you will likely gain the trust & confidence of the client and the beneficiaries as well.

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