MAXIMIZING IRAS: STRATEGIES TO TRANSFER WEALTH TO HEIRS

Recent changes to how non-spousal beneficiaries can receive inherited qualified assets (e.g., IRAs, 401(k)s) may increase the tax burden when the IRA holder dies. The beneficiaries will bear the tax bill on inherited qualified assets irrespective of whether the client's estate is subject to a federal or state death tax. With this popular tax mitigation device no longer available under current law, it may be time to consider alternative tax mitigation strategies.

Qualified plans and IRAs are popular savings vehicles, and with good reason. Qualified plan contributions are generally income-tax deductible, grow tax-deferred, and may be eligible for "matching contributions" by the plan sponsor/employer. As such, qualified plans and IRAs often represent an outsized position in our clients' portfolios.

Unfortunately, qualified assets are less effective as a means of transferring wealth from one generation to the next. Distributions from these assets are generally fully taxable at the recipient's ordinary income-tax rate. When crafting a wealth transfer plan, care should be taken to account for the income tax liability associated with the transfer of these qualified assets, and its impact on the net proceeds passed to the next generation.

THE PROBLEM

Prior to the passing of the SECURE Act,[1] non-spousal beneficiaries (typically, the IRA holder's children, grandchildren, or a "see through" trust for their benefit) were granted the ability to "stretch" the IRA proceeds. A non-spousal beneficiary who elected this option was permitted to take required minimum distributions (RMDs) from the inherited IRA over the course of their life expectancy.[2] This provided two key benefits:

- The beneficiary was only taxed on the RMDs received, which reduced the immediate tax impact by spreading the tax liability over their life.
- The remaining inherited IRA balance stayed invested and tax-deferred, allowing for a longer term of tax deferral and potential growth.

Following the passage of the SECURE Act in late 2019, the stretch IRA was eliminated for non-spousal beneficiaries and replaced with the "10-year rule."[3] Under the new rule, non-spousal beneficiaries are required to have exhausted the inherited IRA by the end of the 10th calendar year following the year of the IRA holder's death. While this can provide some planning flexibility, it can also dramatically shorten the term of tax deferral and increase the beneficiary's income-tax liability.

[1] The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 (Division O of The Further Consolidated Appropriations Act, 2020)

[2] Based upon their non-recalculated single life expectancy; IRS Publication 590-B, Table 1

[3] Exceptions for non-spousal beneficiaries include disabled or chronically ill beneficiaries, beneficiaries not more than 10 years younger than the IRA holder, or a beneficiary who has not yet reached the age of majority.

The tax liability may be compounded by the large size of IRA assets as part of the total inheritance. Many affluent and high-net-worth (HNW) families find that their IRA funds are surplus, and not needed to support their retirement income. As a result, they only take their RMDs beginning at age 72, and nothing more. When combined with a long bull market, it is not surprising to see clients carry significant IRA balances.

A NEW COMBINED ESTATE AND INCOME TAX

With individual estate tax exemptions at $12.06 million in 2022,[4] many clients may be under the assumption that while they may be quite wealthy, their assets will not be subject to federal tax upon their passing. For those with significant IRA balances, the income tax liability on their beneficiaries may be viewed as a "phantom inheritance tax." Indeed, the drafters of the SECURE Act estimate that the tax increases will augment the Treasury by $15.7 billion over 10 years. Any income tax owed by the IRA beneficiary can be partially offset with a deduction for estate taxes paid on the IRA. However, this is a deduction which is not a dollar-for-dollar reduction in income taxes owed. Instead, the deduction reduces the income taxes owed based on the IRA beneficiary's income tax rate. Keep in mind that the deduction can only be taken if the beneficiary elects itemized deductions for the year instead of availing themselves of the standard deduction.

AN EXAMPLE

Let's assume our client is male, age 67, with an IRA balance of $10 million. He does not need this IRA for retirement income and instead wants to pass it to his children.

Option 1: Take RMDs only and reinvest net distribution in a side account

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YEAR	AGE	IRA BALANCE NET ESTATE TAXES	ADDITIONAL INCOME TAXES OWED	IRA BALANCE NET ESTATE AND INCOME TAXES	SEPARATE ACCOUNT NET ESTATE TAX	TOTAL BENEFIT
1	68	$6,420,000	$2,247,000	$4,173,000	$0	$4,173,000
2	69	$6,869,400	$2,404,290	$4,465,110	$0	$4,465,110
3	70	$7,350,258	$2,572,590	$4,777,668	$0	$4,777,668
4	71	$7,864,776	$2,752,672	$5,112,104	$0	$5,112,104
5	72	$8,108,182	$2,791,740	$5,316,442	$197,674	$5,514,117
6	73	$8,348,368	$2,823,894	$5,524,474	$420,149	$5,944,623
7	74	$8,582,450	$2,847,381	$5,735,068	$670,611	$6,405,680
8	75	$8,809,920	$2,861,624	$5,948,296	$950,778	$6,899,073
9	76	$9,028,866	$2,865,322	$6,163,544	$1,263,348	$7,426,892
10	77	$9,239,014	$2,857,978	$6,381,036	$1,610,043	$7,991,079
11	78	$9,436,393	$2,837,225	$6,599,168	$1,995,054	$8,594,222
12	79	$9,618,413	$2,801,369	$6,817,043	$2,421,750	$9,238,793
13	80	$9,782,212	$2,748,563	$7,033,649	$2,893,763	$9,927,412
14	81	$9,927,432	$2,678,188	$7,249,244	$3,413,198	$10,662,442
15	82	$10,048,171	$2,586,831	$7,461,340	$3,985,839	$11,447,179
16	83	$10,144,111	$2,473,850	$7,670,261	$4,613,952	$12,284,213
17	84	$10,208,116	$2,335,167	$7,872,949	$5,304,315	$13,177,264
18	85	$10,240,016	$2,170,169	$8,069,848	$6,059,302	$14,129,149
19	86	$10,235,974	$1,976,375	$8,259,598	$6,883,780	$15,143,379
20	87	$10,191,902	$1,751,157	$8,440,746	$7,782,897	$16,223,643
21	88	$10,109,326	$1,494,658	$8,614,667	$8,758,309	$17,372,976
22	89	$9,978,453	$1,201,330	$8,777,122	$9,819,121	$18,596,244
23	90	$9,801,785	$871,745	$8,930,041	$10,966,630	$19,896,671
24	91	$9,575,918	$503,476	$9,072,442	$12,206,122	$21,278,564
25	92	$9,297,507	$94,093	$9,203,415	$13,543,007	$22,746,421

[4] The Tax Cuts and Jobs Act (TCJA) has temporarily doubled the estate tax exemption for individuals. This provision is set to expire on Dec. 31, 2025 unless otherwise extended.

If the client takes only RMDs and reinvests the net distributions in a side account, his children will receive approximately $20.7 million in year 23 (age 90), assuming:

- IRA and side funds both earn 7% annually
- Client pays an effective tax rate of 35%
- Client is in an estate tax rate of 40%

Option 2: Take distributions and fund a life insurance policy owned by an Irrevocable Life Insurance Trust (ILIT)

The client can take IRA distributions (one option would be in the form of a SPIA), then gift the net distribution to an irrevocable trust to fund a life insurance policy designed to replace the IRA with a more tax-efficient asset. This planning provides approximately $23.2 million in year 23 (age 90)—a 15% increase in money received.

OPTION 2: Take distributions and fund an ILIT-owned life insurance policy

		IRA ACCOUNT				POLICY VALUES				
YEAR	AGE	BEGINNING IRA BALANCE USED TO PURCHASE	GROSS ANNUITY DISTRI-BUTION	INCOME TAXES ON DISTRI-BUTION	NET ANNUITY DISTRI-BUTION	PREMIUM	CASH SURRENDER VALUE	DEATH BENEFIT	CSV IRR	DB IRR
1	68	$10,000,000	$1,579,810	$552,934	$1,026,877	$1,026,877	$424,126	$9,940,495	-58.70%	868.03%
2	69	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$1,344,270	$10,790,923	-25.14%	178.00%
3	70	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$2,311,270	$11,723,731	-13.68%	83.74%
4	71	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$3,365,328	$12,742,259	-7.81%	50.91%
5	72	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$4,521,870	$12,742,259	-4.21%	32.01%
6	73	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$5,762,326	$12,742,259	-1.91%	21.21%
7	74	$0	$1,579,810	$552,934	$1,026,877	$1,026,877	$7,093,667	$12,742,259	-0.33%	14.36%
8	75	$0	$0	$0	$0	$0	$7,487,414	$12,742,259	0.82%	11.60%
9	76	$0	$0	$0	$0	$0	$7,912,002	$12,742,259	1.60%	9.70%
10	77	$0	$0	$0	$0	$0	$8,398,687	$8,818,621	2.23%	2.94%
11	78	$0	$0	$0	$0	$0	$8,972,695	$9,421,329	2.79%	3.41%
12	79	$0	$0	$0	$0	$0	$9,608,151	$10,088,558	3.25%	3.81%
13	80	$0	$0	$0	$0	$0	$10,310,215	$10,825,726	3.65%	4.15%
14	81	$0	$0	$0	$0	$0	$11,084,471	$11,638,695	3.99%	4.44%
15	82	$0	$0	$0	$0	$0	$11,934,309	$12,531,025	4.28%	4.70%
16	83	$0	$0	$0	$0	$0	$12,865,675	$13,508,958	4.55%	4.94%
17	84	$0	$0	$0	$0	$0	$13,884,356	$14,578,574	4.78%	5.14%
18	85	$0	$0	$0	$0	$0	$14,996,670	$15,746,503	4.99%	5.33%
19	86	$0	$0	$0	$0	$0	$16,209,378	$17,019,846	5.18%	5.50%
20	87	$0	$0	$0	$0	$0	$17,528,699	$18,405,134	5.35%	5.65%
21	88	$0	$0	$0	$0	$0	$18,962,201	$19,910,311	5.50%	5.79%
22	89	$0	$0	$0	$0	$0	$20,485,269	$21,509,532	5.63%	5.90%
23	90	$0	$0	$0	$0	$0	$22,102,356	$23,207,474	5.74%	6.00%
24	91	$0	$0	$0	$0	$0	$23,817,526	$25,008,402	5.84%	6.08%
25	92	$0	$0	$0	$0	$0	$25,651,957	$26,678,035	5.92%	6.11%

AN OLD SOLUTION TO A NEW PROBLEM

Life insurance has long been used to replace the wealth lost to estate taxes and to increase the net amount of wealth passed from one generation to the next. While IRA proceeds are generally fully taxable when received (assuming all contributions were pre-tax), life insurance death proceeds are generally received income-tax free by the beneficiaries.[5] Whether individually owned by the insureds or by their trust, life insurance can provide a valuable source of cash to help defray the tax impact associated with the receipt of IRA assets.

For married couples, a survivorship life insurance policy may be an appropriate choice. Survivorship policies insure both spouses and pay a death benefit when the survivor dies. As these policies insure two lives instead of one, they tend to have lower cost of insurance. As a practical matter, this means that a survivorship policy generally has a greater death benefit for the same premium commitment paid for a single life policy. The timing of a survivorship policy is also opportune, paying the death benefit as the IRA assets are passing to the next generation.

THE PROPOSAL

Individuals who do not need their IRA assets to support their retirement income can proactively draw them down and fund a policy insuring one or both spouses with the after-tax proceeds. As the IRA holder is required to take RMDs at age 72, purchasing life insurance is a popular solution. If a client is comfortable with this approach, an earlier purchase can reduce the policy's cost. In most instances, the clients will name their children as beneficiaries of the life insurance policy and the IRA. However, in situations where the client has an estate tax concern, an irrevocable trust can be created to hold the policy. Alternatively, a charitable beneficiary may be named (as discussed below).

POTENTIAL BENEFITS

- Life insurance cash values grow tax deferred.
- Assuming the policy is not a modified endowment contract (MEC), policy cash values may be accessed on a tax-advantaged basis.
- The life insurance death benefit is generally received income-tax free.
- By using an ILIT, the policy can also be sheltered from estate tax.
- Life insurance policies provide immediate death benefit protection and leverage.
- Chronic illness and long-term care riders may be available with the life insurance policy.
- Distributions from an IRA are required to begin at age 72, which provides a convenient source of premium.

CONSIDERATIONS

- Life insurance premiums are paid with after-tax dollars.
- If premiums are sourced from qualified assets, they must be withdrawn from the account first, creating an immediate, income-taxable event to the client.
- An IRA holder under the age of 59.5 who takes a distribution may face an additional 10% penalty tax.[6]
- Availability and pricing of the life insurance policy is based upon medical underwriting.
- Non-guaranteed policies may lapse if inadequately funded or monitored.

DOING WELL BY DOING GOOD—A CHARITABLE OPTION

Public charities, private foundations, and other non-profits do not—as a general matter—pay income taxes. From a tax perspective, at least, this makes them ideal beneficiaries of IRA assets. As previously discussed, IRA proceeds are taxable to the recipient when received. The charitable beneficiary will not have to pay income tax on the IRA proceeds and can use every dollar received. For a family with charitable intent, this can be an attractive option.

This begs the question: "What about the rest of the family?" A survivorship life insurance policy may be used to compensate the next generation. Estate equalization and wealth replacement are long practiced applications of life insurance planning. If a family elects to leave their IRA to charity, it is possible a survivorship life insurance policy can make heirs "whole."

[5] IRC Sec. 101(a)(1)
[6] IRC Sec. 72(t)

The life insurance death benefit may also be left to charity if a couple has additional charitable intent, feels their beneficiaries are already receiving a sufficient inheritance, or are childless. As with most beneficiary designations, this can be changed as the client(s) age and their motivations evolve.

With changes to the inherited IRA rules, it is important to look at techniques to reduce the potential estate and income tax burdens imposed on non-spousal inheritors of IRAs. Those techniques, including the use of life insurance, may help minimize the tax impact and increase the amounts available to heirs.

This piece was created by M Financial's Advanced Markets experts and produced by the marketing team.

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