Life Insurance - IRAs, Taxes & Wealth Transfer

I was once at a conference of Retirement Planners and the question was posed to the group, "Why do you think that the government takes very little encouragement to increase the amount that can be put into a retirement plan vs. the amount of fight it takes to change anything else in and around the tax code?" The answer the speaker gave made a lot sense, "With every increase in retirement that the government allows, it increases the annuity of taxable income it can take from people after they are done working."

IRAs are very commonly used tool for retirement, but it is has tax issues for the next generation. The benefits for those who are living are excellent, but once they pass their beneficiaries are stuck with a fully taxable income which reduces the overall value of their inheritance. Below is a study on a situation like this and simple solution for it.

> James Doe is 67, he spent his working career as a Systems Analyst. When he retired his former employer kept him on as a contractor because of his skill set on a legacy system. James wife passed away about 4 years ago and he primarily will be living on his 1099 Income, Social Security, survivor benefits from her county pension and the proceeds of a life insurance policy. He is basically debt free and has about $1M in an 401(k) he is rolling into an IRA.
>
> At 70 and 1/2 James is still living comfortably. He has not taken any income from his IRA and the IRA itself has grown to almost $1.2M and he now must begin to take Required Minimum Distributions (RMD). He does not "need" this income and after doing a bit of research he learned that his son, Junior, who is the beneficiary of the IRA will be taxed on the benefit after James dies. James' can see this being a growing issue because the IRA is doing well and his main option for the RMD will be to invest in another taxable asset. James knew he did not have enough wealth to have an Estate Planning issue, but he did not foresee that there would be other tax issues he'd have to deal with around inheritances.
>
> James sits down with his CPA to determine the best answer. The CPA recommends that they plan for the taxes on the IRA the same way they'd plan for an Estate issue. The CPA estimates the hypothetical value of James' IRA at his death, then estimates the taxes that Junior would owe on the on the IRA as a lump sum at that age. The CPA then recommends an Insurance Broker to James that works with a variety of carriers that can and will underwrite individuals in their 70s at good rates. James and the Broker choose a carrier and buy a life policy for the amount of the estimated taxes, James uses a portion of RMD to pay the premium, and James Estate Planning Attorney works with James to get the Life Insurance into the most beneficial trust ownership for tax and planning purposes.
>
> When James passes, Junior receives the Life Insurance Death Benefit tax free. In turn Junior uses the benefit to pay the taxes on the IRA, and he is able to use the entire amount of the IRA for his own investments and to the betterment of his family.

When the changes to Estate Taxes were made a few years ago and full portability became the standard I had many people ask me, "What should people do with their old life insurance that they don't need for Estate Taxes anymore?". The answer to me was simple at that time, redirect to the legacy that they see that they would like to carry on either with their family or with a cause. However, when you consider how much wealth is tied up in IRAs right now, a better answer is that these "old life insurance policies" should be redirected to relieve the Income Tax burden you can leave your family even if you are not leaving an Estate Tax burden.