Design an IRA Legacy Plan With Life Insurance

Channeling after-tax individual retirement account distributions into guaranteed no-lapse life insurance can create a significant legacy for your client's heirs.

By Russell E. Towers

With the recovery of the equities markets, it is common for many individuals to have more than $1 million in their individual retirement accounts (IRAs). Many of these IRA owners have multiple sources of income as they approach their retirement years. These sources could include continued income earned through the owner's job, Social Security retirement benefits, K-1 "pass-through" income from ownership of S-corp or LLC entities, and rental income from real estate, as well as other interest, dividends or capital gains from nonqualified financial assets.

These IRA owners understand that they must begin taking required minimum distributions (RMDs) from their IRAs when they reach 70½. The question that typically arises in their financial planning is what to do with the after-tax amounts from their RMDs. For IRA owners with multiple sources of income, these after-tax RMDs usually are allocated as some form of inheritance to their heirs. Should these after-tax amounts simply be reinvested in their nonguaranteed financial asset portfolio, or is there a more tax-efficient way to reallocate these funds in order to provide a larger inheritance to their family?

A concept that can provide a larger after-tax inheritance is commonly known as the "**inherited IRA legacy plan.**" In this plan, after-tax RMDs are allocated to an annual premium for a no-lapse universal life (UL) or no-lapse survivorship universal life (SUL) insurance product. The actuarial leveraging and income-tax-free death benefit can provide a larger inheritance than by simply reinvesting the after-tax RMDs in an asset portfolio with taxable yields. This is especially true in the continuing low-interest-rate environment for fixed financial assets.

A Basic Blueprint for the "Inherited IRA" Using Life Insurance

An "inherited IRA" transaction can help your clients provide a leveraged tax-free fund in the form of life insurance for their heirs.

The first step is to create an income stream from the IRA by taking distributions. An IRA owner doesn't need to wait until age 70½, to take distributions. Some IRA owners may wish to wait until 70½ while others may find it beneficial to start distributions before that. Starting before 70½ may work when coupled with a life insurance program because of the usual higher premium "cost of waiting." Also, the onset of certain medical conditions as we get older may result in less favorable underwriting for life insurance. That may be another good reason to consider taking IRA distributions prior to 70½.

Although the income stream from the IRA is taxable, the after-tax dollars can be used to pay the premium on life insurance that is either owned by the client personally or owned by an irrevocable life insurance trust (ILIT). The decision on whether the insurance is owned personally or by the ILIT will depend on factors such as the value of the IRA and the size of the gross estate in relation to the $5.43 million (single) and $10.86 million (married) federal estate tax exemption in 2015. Also, the simple size of the death benefit may dictate ownership by an ILIT, whether or not the IRA owner has an estate large enough for them to worry about federal estate taxes. However, many IRA owners may be exposed to state death taxes because of the lower state death tax exemptions in many states that still levy them.

Next, the IRA owner must choose a beneficiary for the life insurance. Shall it be the owner's children outright or an ILIT established for their benefit? Or shall it be an ILIT established for the benefit of the IRA owner's grandchildren?

After naming a beneficiary for the life insurance, the IRA owner must name a beneficiary for the IRA. Shall it be the IRA owner's children outright or a trust for their benefit so the inherited IRA can be paid over the children's life expectancies? Or shall it be a trust for the benefit of the grandchildren so the inherited IRA can be paid over the grandchildren's longer life expectancies?

Case Study

Inherited IRA Using After-tax IRA Distributions for Life Insurance Versus Using After-Tax Distributions for Alternative Fixed Financial Asset

Facts of Case Study:

Client and wife are ages 71 and 70, respectively, and have a current gross estate of $5 million. The client owns an IRA worth $1 million and must start taking RMDs. The clients have other sources of retirement income including Social Security and income from rental properties, as well as interest, dividends and capital gains from their nonqualified asset portfolio. They ask you to make a study of what to do with the after-tax RMDs they must begin to take from the IRA. Their combined federal and state income tax bracket is estimated at 35 percent. They believe that an after-tax return on their nonqualified asset portfolio is 5 percent going forward.

Scenario 1: Place after-tax RMDs in an asset allocation portfolio at 5 percent after-tax rate of return (ROR).

The factor from the IRS Uniform Distribution Table for a 71-year-old is 26.5. This means the RMD on the $1 million IRA will be $37,736. In a 35 percent tax bracket, the after-tax amount is $24,528. This after-tax amount of $24,528 will be reallocated each year into the nonqualified asset portfolio with an assumed after-tax ROR of 5 percent.

The joint life expectancy of a 71-year-old man and a 70-year-old woman, according to the IRS Joint Life Expectancy Table, is about 20 years.

An annual deposit of $24,528 into a nonguaranteed financial asset for 20 years at 5 percent after-tax ROR would provide a fund value of $852,000. This is the hypothetical nonguaranteed amount that would be inherited by the heirs of the client and his wife.

Scenario 2: Place after-tax RMDs in a no-lapse SUL policy for a 71-year-old man and a 70-year-old woman (both standard nonsmoking).

The factor from the Uniform Distribution Table for a 71-year-old is 26.5. This means the RMD on the $1 million IRA will be $37,736. In a 35 percent tax bracket, the after-tax amount is $24,528. In this scenario, this after-tax amount of $24,528 will be reallocated each year into a premium for a no-lapse SUL insurance policy issued by a competitive carrier.

For an annual premium of $24,528, the clients can purchase a guaranteed SUL death benefit of $1,172,000 right from the beginning. This benefit is the tax-free amount the heirs would receive at the death of the survivor of the client and wife. The internal rate of return (IRR) at year 20 joint life expectancy is 7.72 percent. In a 35 percent tax bracket, the pretax equivalent IRR is 11.88 percent.

However, if both the 71-year-old man and the 70-year-old woman would be healthy enough to receive a preferred nonsmoking rate, the $24,528 annual premium would purchase a guaranteed SUL death benefit of $1,352,000. The IRR at year 20 joint life expectancy is 8.90 percent. In a 35 percent tax bracket, the pretax equivalent IRR is 13.69 percent.

The Benefits of an Inherited IRA Plan With Life Insurance

The benefits of channeling after-tax IRA distributions into guaranteed no-lapse life insurance are significant. When compared with the taxable yields of alternative fixed financial assets (money market funds, certificates of deposit, bond funds or U.S. government securities), in the continuing low-interest-rate environment, the net results are truly outstanding.

The IRA-SUL insurance plan I have described can increase the amount of net inheritance available upon the insureds' deaths. When compared with alternative fixed financial assets, the net inheritance to the heirs of this IRA-SUL insurance plan is hypothetically improved by about $320,000 at joint life expectancy (20 years) with standard medical underwriting. With preferred medical underwriting, the net inheritance to the heirs of the IRA-SUL insurance plan hypothetically improves by about $500,000 at joint life expectancy (20 years) when compared with alternative fixed financial assets.

Then there is the matter of guarantees. The SUL insurance provides a guaranteed no-lapse benefit versus a nonguaranteed accumulation value of the alternative fixed financial asset. The nonguaranteed "cross-over" point, where the nonguaranteed financial asset hypothetically exceeds the guaranteed standard underwriting SUL death benefit, does not occur until year 25, when the younger insured, if still alive, is age 95. The nonguaranteed cross-over point, where the nonguaranteed financial asset hypothetically exceeds the guaranteed preferred underwriting SUL death benefit, does not occur until year 27, when the younger insured, if still alive, is age 97.

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The IRA-SUL plan also can be structured in a way that addresses state death taxes. The SUL insurance could be owned by an ILIT so that the death benefit is estate tax-free for state death tax purposes. The $5 million taxable estate in our case study would generate upwards of about $391,000 of state death taxes in a state that still uses the tax table from Internal Revenue Code Section 2011. Part of the SUL death benefit could be used to offset these state death taxes, with the rest of the death benefit managed by the trustee for the benefit of trust beneficiaries.

At the client's death, the remaining IRA value is paid outright to the children or to a separate trust for the benefit of the children or grandchildren as an inherited IRA. The RMDs using the Single Life Table can be "stretched" over the remaining life expectancies of the children or grandchildren, depending on the dispositive provisions of the trust document. Using this inherited IRA stretch method, the income taxes to the heirs are spread out and paid annually over many years into the future rather than paid in a lump sum and taxed all in one tax year.

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