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Goodbye Stretch, Hello Life Insurance

The general rule of thumb in the past for retirement savings was to use qualified plans to lower one's current tax obligation, defer them in the present, and withdraw them in the future at a lower rate. A key benefit was that if the funds were not totally withdrawn before the owner's death, the balance could be left to someone else and spread over their life expectancy. Starting January 1, 2020 this is no longer the case, except for a small group of eligible designated beneficiaries. Now, many inherited retirement accounts must be distributed within 10 years following the year of the participant's death. Because of this compressed 10-year distribution period, heirs are likely to be pushed into higher tax brackets, making retirement accounts a less attractive wealth transfer vehicle.

The New Rules Upend a Central Maxim to Retirement Savings

For people who have been successful in saving for retirement and who have established a large enough nest-egg to be able to create a legacy for their children, grandchildren or favorite charities, the new rules have upended a central maxim to retirement savings. For these people a common question will be whether they should continue to take as little as possible during their lifetime under a "stretch" RMD concept, leaving as much of the retirement account (and its tax burden) as possible to their heirs, or whether they should explore alternative strategies. Following are some of the strategies where life insurance plays a role.

1 Tax Offset Strategy

Where your client's retirement account beneficiaries are likely to be in a higher income tax bracket, it may make sense for the qualified participant to take larger withdrawals than RMD, or to begin to take distributions prior to the required beginning date (now age 72). This may help pay for a life insurance policy equal to the beneficiary's projected income taxes (which most carriers will permit face amounts equal to 40-50% of current account balance). With this strategy, the beneficiary receives life insurance death benefits income tax-free and can use those funds to pay the taxes due on the inheritance.

2 Participant Roth Conversion Strategy

One way to remove the impact of a higher tax burden for beneficiaries as a result of the stretch demise is to simply eliminate the tax burden by making lifetime Roth conversions. This strategy is especially attractive today where a retirement plan participant may be in a lower bracket than in the future when rates may jump. The downside to this strategy is that income taxes are due at the time of conversion. For a period of time after the conversion the participant will be worse off and if they happen to die during this time the conversion will not be effective. This risk of an early death can be covered with life insurance. The amount of life insurance will depend on the client's specific situation.

Spousal Roth Conversion Strategy

Where your plan participant's spouse is the sole beneficiary of the retirement account at the participant's death, it may make sense for the spouse to elect a rollover to their own name followed by conversion to a Roth. With this strategy the beneficiary spouse can continue to defer accumulation on the account for life and at death distributions are income tax-free to the heirs. Of course, at the time the spouse does the Roth conversion income taxes will be due. Therefore, like the above situation it may make sense for the participant to purchase a life insurance policy on his/her life equal to the projected income-taxes the spouse will owe.

Charitable Strategies

If you have a client that would like to make a bequest to a charity, it has long made sense for those individuals to leave their favorite non-profit their pre-tax IRAs. The qualified participant can do this either during his or her life by doing a qualified charitable distribution from an IRA or at death as a beneficiary designation. A charity can cash in a tax-qualified retirement asset such as an IRA at no income tax cost – and if there is a concern with estate taxes, anything left to charity is excluded from estate taxation. This strategy can be taken one step further to incorporate an heir. Like the above situation it may make sense to purchase a life insurance policy equal to the value of the retirement asset that will be left to the charity. With this strategy both the charity and heir receive income tax-free benefits.

Another charitable strategy can be used by retirement account owners who really want their beneficiaries to stretch distributions. With this strategy the retirement account owner leaves their qualified accounts to a charitable remainder trust (CRT). While the CRT doesn't actually preserve stretch since the retirement benefits will need to be paid to the CRT as a non-designated beneficiary under the 5-year rule, the CRT can be designed to replicate the primary benefits of stretch including tax-deferral and a lifetime income stream for the non-charitable beneficiary.

Specifically, since a CRT is a charitable entity the entire qualified account can be distributed to it without income tax liability. Also, they also grow tax-deferred. Once the funds are in the CRT they must be distributed according to the terms of the CRT document. Such distributions are limited by IRS rules, but must generally be between 5%-50% of the trust assets with the caveat that there must be a charitable remainder equal to 10% of the trust's initial value at the termination of the trust. The non-charitable beneficiary is taxed upon distribution from the CRT. Again, it may make sense to purchase a life insurance policy on the retirement owner's life equal to the value left to the charity. Some carriers may permit a face amount equal to the account balance left to the CRT.

How Can DBS Help?
Perhaps the most valuable thing an advisor can do right now is present the mitigation strategies available to their clients. For more information about these strategies contact DBS's inhouse advanced case design resource Terri Getman, JD, CLU, ChFC, RICP, AEP (Distinguished) at extension 230.