M INTELLIGENCE

REDUCING TAXES ON INHERITED RETIREMENT ACCOUNTS

Retirement accounts such as IRAs and 401(k)s can be effective vehicles for tax-deferred savings and growth. Millions of Americans rely on them to fund a major portion of their retirement. But for individuals with large sums in these accounts, they can pose an unexpected long-term problem: They are poor wealth transfer tools when left to someone other than a spouse.

When passed to a beneficiary other than a spouse (and few limited additional exempt family members), your retirement account could:

- lose up to half its value in income taxes alone.
- bump your beneficiary into a higher tax bracket, which would reduce the asset even further.
- be included in your taxable estate — possibly subjecting all of your assets to estate taxes.

For these reasons, you may wish to consider a strategy utilizing distributions to purchase a permanent life insurance policy. By using this strategy, you may be able to reduce taxes for your beneficiaries and leave a larger legacy.

PROBLEM #1: THE IMPACT OF INCOME TAXES

When someone other than a spouse inherits a traditional/SEP IRA, 401(k), or other retirement plan, the account distributions are taxed as ordinary income at both the federal and state level.[1]

For example, a child inheriting a SEP IRA worth $10 million could pay as much as $5 million in income taxes[2] alone, depending on when the money is withdrawn and their state of residency. And while this amount may seem staggering, it's unlikely that tax rates will decrease in the future. In fact, with current Social Security and Medicare shortfalls, it's possible that federal income taxes will actually increase — which would take an even bigger bite out of your beneficiary's inheritance.

THE SECURE ACT

If someone other than a spouse is the beneficiary of your retirement account, they may also inherit less after taxes due to the passing of the Setting Every Community Up for Retirement Enhancement (SECURE) Act. Effective January 1, 2020, this federal regulation dictates that inherited funds from IRAs, 401(k)s, and similar accounts must be withdrawn no later than the 10th anniversary following the calendar year of the original account owner's death.

SECURE Act Exclusions

Eligible designated beneficiaries (EDBs) are excluded from the 10-year rule of the SECURE Act. They are defined as:

- a surviving spouse.
- a person who is disabled or chronically ill.[3]
- a minor child.[4]
- an individual not more than 10 years younger than the account owner.

Before the SECURE Act, all retirement account beneficiaries could implement a "stretch" tactic, which is a strategy of taking no more than the required minimum distributions (RMDs) each year. These RMDs could be based on beneficiaries' own life expectancies, which could make the distributions much lower for younger beneficiaries.

Stretching out the distributions this way increased the value of the inheritance in the long run, since most of the account could be left intact to continue its tax-deferred growth. It was also a way to prevent beneficiaries from paying a greater percentage in income taxes, as smaller withdrawals are less likely to bump them into a higher tax bracket.

Due to the rules of the SECURE Act, your non-spousal beneficiaries will likely be forced to empty the account within a decade, which can increase their tax burdens and decrease the account's long-term value.[5] In other words, the net legacy received by other beneficiaries, such as your children and grandchildren, is likely to be less than what it would have been prior to the SECURE Act's passage.

PROBLEM #2: ESTATE AND INHERITANCE TAXES

In addition to income taxes, your retirement account could suffer another tax hit if it tips your total estate value over estate and inheritance tax exemption levels. With the federal exemption amount due to drop from $12.92 million (2023) to approximately $6.2 million January 1, 2026 (known as the sunset provisions), a large retirement account increases the likelihood that your estate will be subject to federal estate taxes upon your death.

The funds could also incur state estate and/or inheritance taxes as well, depending on state of residency. As of 2022, 17 states[6] (and D.C.), levy some sort of estate and/or inheritance tax. Some of these taxes are as high as 20%.

POSSIBLE SOLUTION: INCREASING WEALTH TRANSFER WITH LIFE INSURANCE

With advanced planning, you can greatly reduce taxes for the non-spousal beneficiaries of your retirement account. If you won't need access to these funds in the future, you may wish to use distributions[7] to purchase a life insurance policy. Unlike most retirement accounts, life insurance proceeds are generally inherited free of income tax **regardless of the beneficiary's relationship to the insured**. Also, the beneficiaries of a life insurance policy will not face any RMDs or the 10-year withdrawal deadline required by the SECURE Act.[8]

In addition, if estate taxes are a concern, a life insurance policy can be structured so that the proceeds are not included in your taxable estate. You can establish an irrevocable life insurance trust (ILIT)[9] and gift distributions (assuming either your annual exclusion or lifetime gift exemption is available) from the retirement account to the trust, which can then purchase the policy. As long as incidents of ownership[10] are avoided, the death benefit of the policy inside the ILIT will be excluded from the estate and, therefore, not incur estate taxes. Retirement accounts, on the other hand, cannot be put into a trust while the owner is alive and are **always** included in the estate when the beneficiary isn't a spouse.

THE BEST TIME TO TRANSFER FUNDS

Moving funds from an over-funded retirement account to a life insurance policy can be particularly effective if you are between ages 59½ and 72 since there aren't any early withdrawal penalties after age 59½. You are also likely to be more insurable at a younger age.

This strategy can also be effective if you are currently 72 or older and taking RMDs, since you must withdraw funds anyway. However, insurance premiums may be higher, requiring a careful cost-benefit analysis to determine if the strategy makes sense.

Increasing Inheritance by Reducing Taxable Retirement Income

Reducing future estate taxes is only part of the solution. Reducing your income tax obligations while you're living can also increase the value of your retirement assets and potentially create a larger legacy.

As with beneficiaries being bumped into higher tax brackets with RMDs, the same can happen to you during retirement. A common assumption is that taxable income is lower in retirement but, if you have substantial assets, this won't necessarily be the case. Instead, you may find yourself in the same or even a higher tax bracket, especially when the RMDs are withdrawn.

Large RMDs can also equate to higher Medicare premiums in retirement. Referred to as means testing, the premiums for Medicare Parts B and D are based on income. If you have done "too good" of a job saving into your retirement account, you will likely end up paying significantly more for your health insurance over time.

If these scenarios could apply to you, you may wish to shift a portion of your traditional/SEP IRA, 401(k),[11] or similar account to a Roth IRA/401(k), as well as purchase a permanent life insurance policy. Since both the Roth IRA/401(k) and life insurance policy allow for tax-free distributions,[12] you will be able to access extra funds without incurring additional tax liability.

For example, if a retired couple needed an annual income of $350,000 to maintain their lifestyle, they could withdraw $300,000 from a traditional IRA, $25,000 from a Roth IRA, and $25,000 from their life insurance policy's cash value. Since the latter two distributions can be received tax-free, they would only pay income taxes on $300,000, despite receiving $350,000 for the year. In addition, this reduction in taxable income could move the couple into a lower tax bracket (depending on rates at the time of withdrawal), increasing their tax savings even further.

The year-over-year reduction in taxes can allow the couple to increase their net worth. This additional wealth, along with the death benefit of the life insurance policy, could provide their beneficiaries with significantly more.

COMBINING CHARITABLE GIVING WITH LIFE INSURANCE

Leaving a legacy can extend beyond loved ones. With the right planning, the charity of your choice can also be one of your retirement account's beneficiaries. The advantage to naming a charity as a beneficiary is that those that qualify under IRC Section 501(c)(3) generally receive donations tax-free, which means the value of the asset will remain intact upon transfer.

If you want to split your retirement account between your family and a charity, you could place it into a charitable remainder trust (CRT). CRTs are irrevocable trusts that can provide extra income for your beneficiaries while also creating a donation to charity.

The advantage of CRTs is that they are not subject to the SECURE Act's 10-year limit and can be left to grow for decades. Also, since your family members will only be receiving a portion of the account, this strategy may help them avoid being bumped into higher tax brackets.

There are guidelines, however, and they include the following:

- The annual payout to your non-charity beneficiary must be at least 5% but no more than 50% of the asset's value.
- The charity must receive at least 10% of the initial asset's value at the end of the trust term.
- Individual beneficiaries can receive income from the trust for up to 20 years or for life.

Naming a charity as a beneficiary of your account does, of course, divert funds away from your loved ones. To make up for the loss, you can purchase a life insurance policy with a death benefit equal to, or even greater than, the value of the donation. Although the net result to your family will still be less than the full retirement account and death benefit combined, this method allows you to leave a tax-free legacy for both.

PROTECTING GENERATIONAL WEALTH

Income and estate taxes can diminish the value of your retirement account, leaving less for your beneficiaries. The passing of the SECURE Act, along with impending changes to estate tax minimums, can also make this asset less valuable in the future.

If you have a substantial amount tied up in your retirement account, taking distributions to purchase a life insurance policy can help you leave a larger legacy to your family — and allow for a charitable donation as well. Working with an experienced financial professional can help you develop strategies, which include life insurance, that can offer tax-free benefits that improve the quality of life for generations to come.

This piece was created in collaboration with the M community's life insurance experts and produced by the marketing team.

[1] Roth IRA/401(k) distributions are usually exempt and received income tax-free if the owner is at least 59½ and the account has been open for five years or more. Other exceptions apply.

[2] Based on 2022 federal tax rates plus applicable state taxes. Actual tax liability can vary, depending on life factors and when distributions are taken.

[3] Trusts created for the benefit of a chronically ill or disabled person are included.

[4] Grandchildren are not included. Once the minor reaches majority age, the 10-year rule applies.

[5] In late February 2022, the IRS issued proposed regulations on RMDs for inherited retirement accounts. The department stated that not only must beneficiaries liquidate the assets within 10 years, but they must make a distribution — based on life expectancy — for each year of the 10-year term. If not, they would be subject to an onerous 50% excise tax on the amount that should have been withdrawn. In October 2022, the IRS provided Notice 2022-53 which states the IRS will not impose the 50% excise tax for failure to take RMDs in 2021 and 2022.

[6] As of 2022, the states that levy an estate and/or inheritance tax are CT, DC, HI, IL, IA, KY, ME, MD, MA, MN, NE, NJ, NY, OR, PA, RI, VT, WA.

[7] Distributions may be taxed as ordinary income. A 10% penalty may apply for withdrawals before age 59½.

[8] Although there is no deadline for withdrawing a life insurance death benefit, the beneficiary can owe taxes on any interest earned during a delayed payout.

[9] Setting up an ILIT requires careful planning. Be sure to consult with an experienced professional.

[10] Incidents of ownership include the right to change the beneficiaries, borrow from the cash value, or alter the policy in some other way.

[11] Distributions may be taxed as ordinary income. A 10% penalty may apply for withdrawals before age 59½.

[12] Roth IRA distributions may be subject to income tax if taken within five years of opening and/or before age 59½. Cash value loans or withdrawals from a life insurance policy are tax-free up to the policy's basis but can decrease the death benefit to beneficiaries.

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