

NicheAlert

Solving the Challenge of a Stretch IRA

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While the recently passed SECURE Act 2.0 is generating quite a bit of conversation in retirement planning circles, it has not had near the impact in the life insurance segment that the original SECURE Act did when it was passed back in late 2019. The primary impact of SECURE 1.0 in the life insurance space was the significant change to Stretch IRA rules, making inherited IRAs even more of a tax challenge for beneficiaries. Read on to learn more about a strategy to work with both G1 and G2 for a comprehensive solution!

In an ironic twist, planning opportunities stemming from SECURE 1.0 focus not as much on the taxes paid by beneficiaries, but on the “G1” IRA owner who has had the good fortune to accumulate a large qualified plan balance and the ability to fund a traditional IRA Maximization strategy involving current distributions to fund a life insurance policy with far more favorable tax treatment. This presents some planning obstacles for all involved, including:

- G1 IRA owners who may not be concerned about the tax implications for their beneficiaries, believing that they are “getting enough” simply by inheriting any assets not consumed during G1’s lifetime net of any taxes.
- Even if G1 does care about the tax issue, they may not be insurable, eliminating the viability of the strategy entirely.
- For those clients that execute traditional IRA Maximization, there will almost certainly be a remaining qualified plan balance that will be heavily taxed upon passing to G2.

This last issue, the remaining balance inherited by G2, has two components:

- Income taxes due on the inherited amount over the ten-year period mandated by SECURE 1.0.
- Taxation of any gains on the net proceeds that are then invested.

Fortunately, many of the challenges listed above are easily solved with a life insurance strategy focused on G2. By establishing a permanent life insurance policy as part of G2’s retirement planning approach, there is the possibility of avoiding the taxes that would be due on gains from other asset types. This policy is funded by a portion of the inheritance, and are a number of design elements to consider to render it maximally effective:

- Consider using a face amount in excess of the minimum required to accommodate the portion of the inheritance allocated to the strategy.
- The “balanced” approach to the design will also increase any amounts available via accelerated benefit provisions included in the base policy or added via rider, strengthening G2’s care planning strategy.
- Availability of participating loans early in the policy could allow for higher funding levels, subsequently using a policy loan to pay taxes when due in April of the following year, versus holding a portion of the proceeds back in anticipation of future taxation.

Another consideration is one of timing. While the fact that there is a future inheritance may be known fairly early on, the timing of the event is obviously unknown. This could present a problem if there are insurability issues for G2 that present themselves at the time of the inheritance. The solution to this challenge is to put the insurance in force on G2 early in the process, in anticipation of the future inheritance. Doing so eliminates insurability as a future unknown and would also become part of G2’s overall retirement planning. Having a tax-favored source of retirement income above and beyond the ability to accommodate the inheritance strengthen the resilience of their overall retirement plan. If this approach is pursued, the use of a policy face amount higher than the minimum required for G2’s premium budget at inception creates the capacity to accommodate the future inheritance.

While this strategy has been described as a way to solve the issue of not being able to execute a traditional IRA Maximization strategy, the use of these two strategies in concert would be maximally effective in terms of reducing taxation of the IRA and minimizing G2’s tax burden on a forward-looking basis. This “second sale” to G2 in an IRA Maximization strategy can also be used to prospect up or down the family tree, depending on where the original client relationship lies.

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