FREMONT AREA
COMMUNITY
FOUNDATION

Friday, March 12, 2021

Transferring Your IRA
David Landheer, Insurance Advisor

David Landheer is an insurance advisor with Landheer Insurance Agency in Fremont and is a member of the Community Foundation's Professional Advisors Board.

You've saved well and built up your retirement funds with qualified plans such as individual retirement accounts (IRAs). Now, you're thinking you won't need all of it for retirement—and you're considering passing some funds to the next generation.

Is there another way to pass your IRA to your heirs? Yes. Passing on qualified assets can be challenging. But by being prepared and pre-paying your beneficiary's taxes, you can do it efficiently.

First, let's explore some of the pitfalls when transferring IRAs:
1. Distributions from IRAs are income taxed. Because IRAs are funded with pre-tax dollars, distributions from these accounts are subject to individual income taxation.

2. IRAs can be subjected to estate tax. IRA assets remain in your estate upon your death, subjecting them to possible estate taxes. Even if you're not currently subject to estate tax, tax laws can change, making individuals with even modest estates potentially subject to estate tax.

3. Stretch IRA laws have changed. With passage of the Setting Every Community up for Retirement Enhancement (SECURE) Act, beneficiaries of an IRA must spend down that asset within 10 years, with some exceptions for individuals known as eligible designated beneficiaries. Prior to this law, beneficiaries inheriting these accounts were able to stretch the required distributions over their lifetime—reducing the annual distributions and lowering taxes due.

4. Your heirs may be in their highest tax bracket. Typically, when a beneficiary inherits an IRA from a parent, they're often older and in their peak earning years, putting them in high tax brackets. Coupled with having to deplete an account within 10 years, the tax impact can be significant.

4424 W 48th Street Fremont, MI 49412 P 231.924.5350 F 231.924.5391 facommunityfoundation.org

The solution: pre-pay your beneficiary's taxes. Allow your heirs the flexibility to enjoy their inherited IRA most efficiently by funding a life insurance policy with a tax-free death benefit. This gives them options with inherited IRAs: take a lump sum distribution or stretch over the 10 years and pay the tax with the death benefit.

To pre-pay your beneficiary's taxes, first purchase life insurance to cover the taxes owed on IRAs passing to heirs. Funding for life insurance premiums can come from after-tax distributions from your qualified plan, another asset account, or current income.

Upon your death, your remaining qualified plan assets pass to your heirs. In addition, they'll receive the life insurance death benefit income tax-free. Your heirs may then choose a lump-sum distribution from the inherited IRA and use the death benefit to pay the income taxes generated from the IRA distribution/liquidation.

There are several potential benefits to pre-paying your beneficiary's taxes. Not only is the death benefit to your heirs income tax-free, but by pre-funding the tax liability on the IRA with life insurance, you may be able to reduce the overall cost of transferring the asset to your heirs. If the life insurance has cash value, you may be able to access those dollars during the insured's lifetime if you own the policy. Your heirs can also decide when they access the money from the death benefit or the IRA you left to them; it's not based on a government table.

Along with these benefits are a few potential risks to watch out for. Income taxes will be due on distributions from the qualified plan and distributions prior to age 59½ from a qualified plan may be subject to an additional 10 percent penalty. The insured must be underwritten for the life insurance you purchase. Policy loans and withdrawals may also create an adverse tax result in the event of a lapse or policy surrender and will reduce both the cash value and death benefit.

Changes in tax rates and circumstances over time can also impact the effectiveness of this strategy. Be sure to work with your professional advisor to create a plan that will work best for you and your loved ones.