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Goodbye Stretch IRA, Hello Life Insurance Opportunities

For generations, life insurance has been a significant part of the overall financial planning process. The ability to provide for others when a loved one dies continues to be one of the most important aspects of the product. According to LIMRA, the top three reasons Americans give for owning life insurance are to:

- Cover burial and final expenses (91 percent)
- Help replace lost wages/income of a wage earner (66 percent)
- Transfer wealth or leave an inheritance (63 percent)[1]

In addition to life insurance, clients utilize other assets in their portfolio to transfer wealth or leave an inheritance. Most notably, Individual Retirement Accounts (IRAs) or employer-sponsored retirement plans (e.g., 401(k) plans) are used in this capacity. The Required Minimum Distribution (RMD) rules have, to date, permitted non-spouse beneficiaries of these accounts to take distributions over their life expectancies. Commonly referred to as “stretching” the account, this enabled beneficiaries to spread not only the distributions, but also the income taxes.

However, the passage of the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) in December 2019 changes the wealth transfer landscape. Now, IRAs and defined contribution plans become much less attractive wealth transfer vehicles. Non-spouse beneficiaries can no longer stretch their inherited IRA asset distributions (and taxes) over their lifetimes.

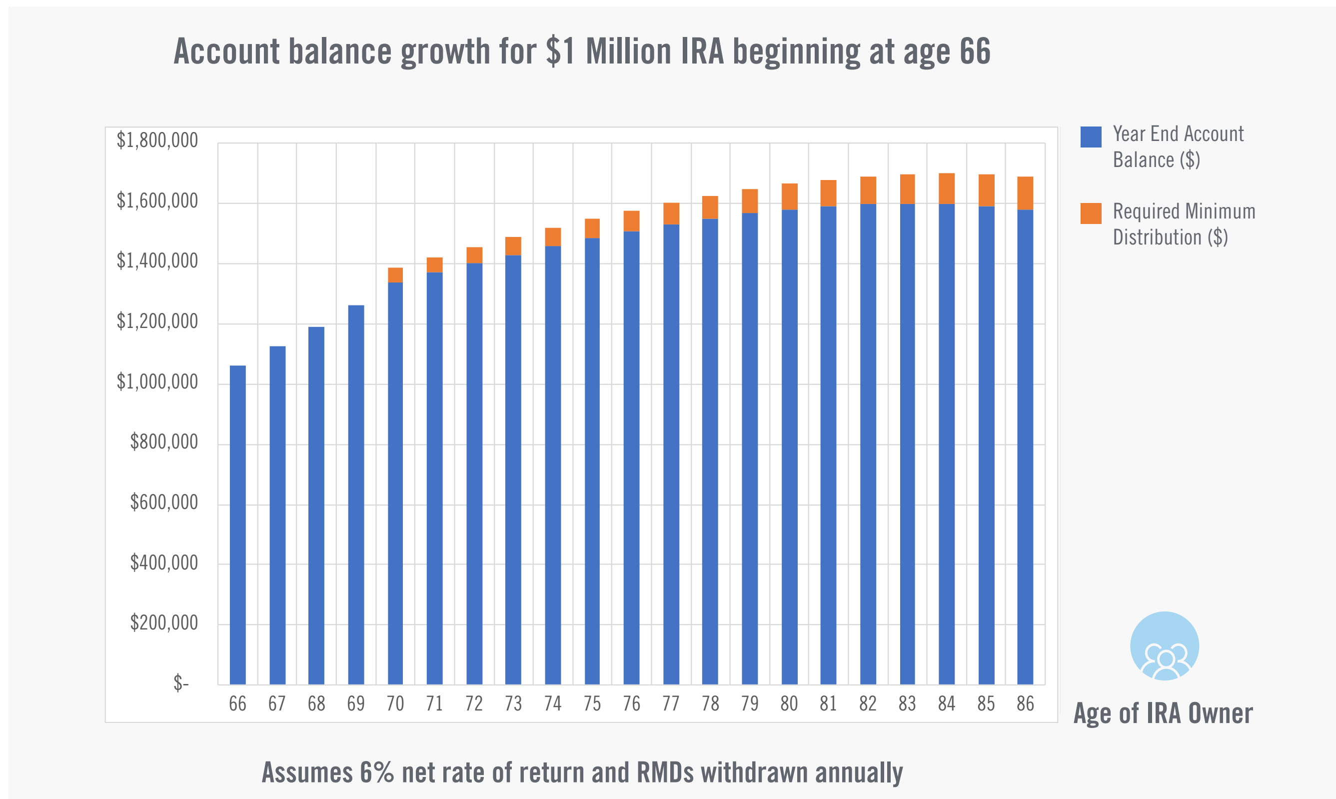
[1] LIMRA, “Facts About Life 2018”, September 2018.

These assets, with a few limited exceptions, can pass to a spouse without facing this tax but on the spouse's death, the tax will be due. All inherited IRA assets by a non-spouse beneficiary, with limited exceptions (including those who are minor children or disabled), must be distributed within ten years of death of the IRA owner. Consequently, these assets will frequently become a huge deferred tax liability since those ultimately inheriting the funds (which will often be the children) are likely to see their assets taxed at very high marginal rates. For example, a married New Jersey couple earning $200,000 who inherits a $500,0000 IRA in 2027, can be projected to pay approximately 40% in a combined federal and state tax rate when the assets come to them. The after-tax value of the $500,000 account thus sinks to $300,000. In addition, the inherited assets could force other investment income to become subject to the 3.8% Medicare tax. If the beneficiaries were Medicare eligible, the inheritance could also trigger much higher Medicare premiums.

The Value of a Stretch IRA

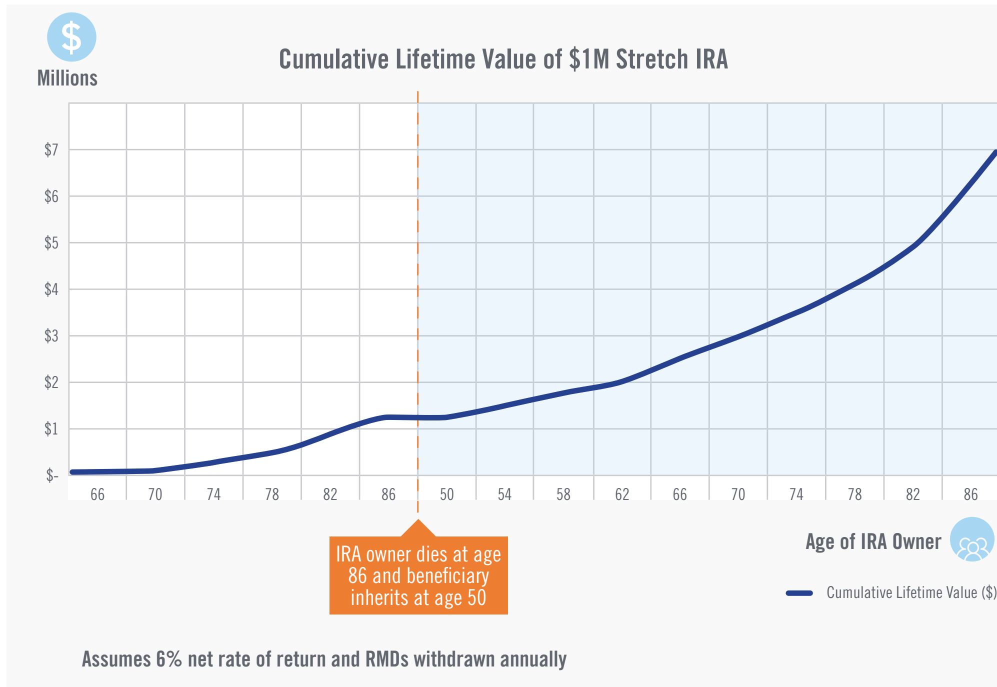
Let's look at the landscape that existed prior to the SECURE Act. IRAs can increase substantially over a retiree's lifetime as solid investment growth can exceed the RMDs taken. As shown in Figure 1, $1 million at age 66 will increase by 47% to $1.47 million by age 86 if 6% growth is assumed. Under prior law, the full amount of $1.47 million could then be stretched by the next generation who inherited the account and only RMDs would need to be withdrawn based on the life expectancy of the inheritor.

Figure 1



With an adult child inheriting the account at age 50, who subsequently lives 36 years and dies at age 86, the lifetime value of the $1 million account becomes approximately $7 million at an assumed 6% annual investment return. The delay in taxation allows the assets to grow exponentially. It's no surprise the government wished to curb the use of Stretch as significant tax revenue was lost, at least in the short term. See Figure 2.

Figure 2



Life Insurance to Pay Death Taxes

Estate planning will once again involve the use of life insurance to pay death taxes, but this time, it will be federal and state income taxes on IRAs and defined contribution plans, as opposed to federal estate taxes. For married couples, a second-to-die life insurance policy may be appropriate to reduce the premiums but also to recognize that the income tax will be paid not when the spouse inherits an IRA or defined contribution plan, but when the children do.

Ninety-four percent of traditional IRA investors over age 70 who took withdrawals in 2018 took just the RMD amount.

Look at what happens over time to the $1 million account shown in Figure 1 under the new law. While RMDs start at age 72 effective in 2020 (as opposed to 70 1/2 under prior law), a significant amount of taxes is now due within 10 years of the death of the owner. If the IRA has grown to $1.58 million at the IRA owner's death and the beneficiary chooses to pay the taxes upon inheritance, the tax bite is $632,000 at an assumed 40% tax rate. The beneficiary may choose instead to let the IRA grow the maximum amount of time to capitalize on tax deferral. If the account grows at 6%, the account has grown to $2.8 million and $1.1 million would be due in taxes at a 40% rate.

An added benefit of life insurance which is put in place to pay income taxes is that the IRA or defined contribution plan may not have to be liquidated to pay taxes due during a bear market. Conversely, children inheriting such an account without life insurance coverage in place may be forced to lock in losses and liquidate a significant portion of the account to pay taxes due.

The question thus arises, "just how common is it that retired IRA owners just take the RMD?" According to the Investment Company Institute (ICI), it is quite common. Ninety-four percent of traditional IRA investors over age 70 who took withdrawals in 2018 took just the RMD amount.[2]

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[2] Investment Company Institute, "The Role of IRAs in US Households' Saving for Retirement, 2019", ICI Research Perspective, Vol. 25, No. 10, p. 27, December 2019.

Life Insurance Funded by an IRA

With a projected tax liability time bomb on their IRA or retirement plan ahead, creative planning will likely also involve healthy older account holders making larger withdrawals from their accounts, paying taxes due (at a rate lower than their children would eventually pay on the inherited IRA), and then using the net proceeds to pay the premium on a life insurance policy. A tax-free death benefit can be provided to heirs in lieu of an account that will be taxed at high marginal rates.

Permanent Life Insurance as an Alternative and Complement to 401(k) Investing

Since the value of 401(k) investing is now more limited, financial advisors have the opportunity to sell more permanent life insurance as a wealth building alternative. For example, a 50 year-old earning $150,000 who has accumulated $300,000 in her 401(k) may wish to diversify her portfolio with permanent life insurance because, assuming a 6% rate of return, her 401(k) will be expected to grow to $762,000 by age 66 and then, ignoring RMDs, by 221% more (to $2,444,000) by the time she is 86. At a 40% tax rate, her heirs are already facing a projected $977,000 tax bill if they pay the tax upon inheritance and an even larger amount if they defer taxes an additional ten years.

Needless to say, the opportunities for permanent life insurance sales have grown exponentially as the landscape has shifted. Opportunities have risen and financial advisors who capitalize first may see the greatest advantage in building their practice.[3]

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[3] Prudential calculations.

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