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Individual Life Insurance

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Pre-paying your beneficiary's taxes

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.

The 4 problems with IRA transfers

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.

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.

What are qualified plans?

- **401(k)s**
- **Individual Retirement Accounts (IRAs)**
- **Simplified Employee Pensions (SEPs)**
- **Savings Incentive Match Plan for Employees (SIMPLE) IRAs**

Upon the death of the qualified plan account holder, these assets are turned into an inherited IRA.

How pre-paying your beneficiary's taxes works

1

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
- Current income

2

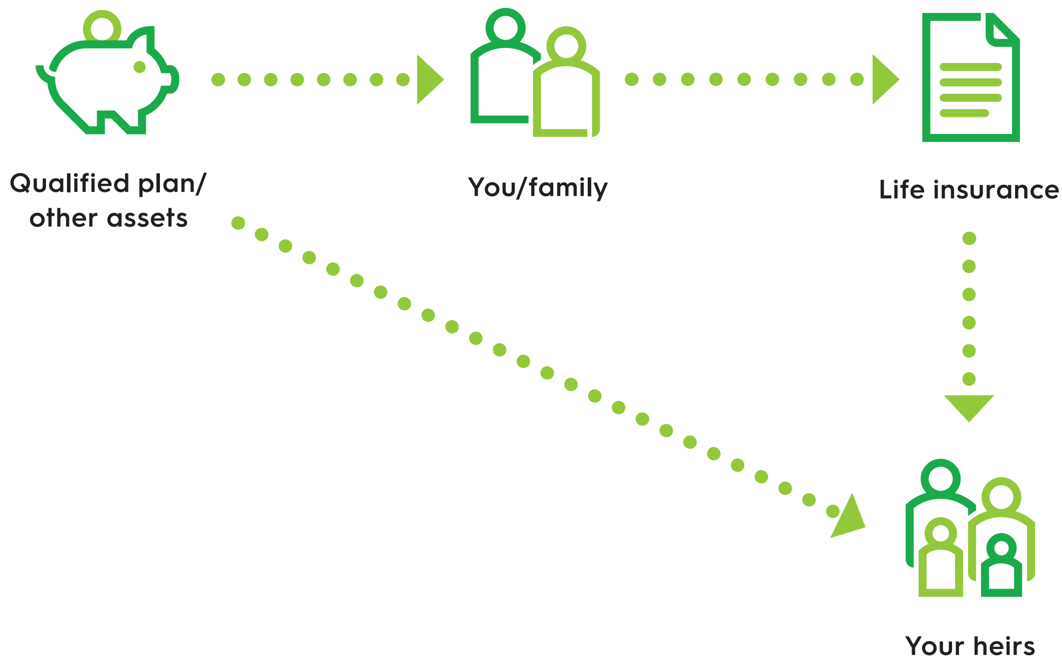
Upon your death,[1] your remaining qualified plan assets pass to your heirs. In addition, they'll receive the life insurance death benefit income-tax free.

3

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.

4

Life insurance can be placed in a trust to address future needs, such as estate taxes.



1. If owner and insured are different, the death benefit will be paid upon death of the insured.

Potential benefits:

- The death benefit to your heirs is income-tax free.
- 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 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.

Potential risks:

- Income taxes will be due on distributions from the qualified plan.
- 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.
- Tax rates may change over time and make the strategy less attractive.
- Life changes may require you to use plan assets for living expenses, which could put funding of your life insurance policy in jeopardy.
- Policy loans and withdrawals may create an adverse tax result in the event of a lapse or policy surrender and will reduce both the cash value and death benefit.

Learn more

Is pre-paying your beneficiary's taxes a good option — based on your situation? Talk to your financial professional today. They can help you evaluate the pros and cons, and create the best approach that works for your family.

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Life insurance products contain fees, such as mortality and expense charges (which may increase over time), and may contain restrictions, such as surrender periods.

Policy loans and withdrawals may create an adverse tax result in the event of lapse or policy surrender and will reduce both the surrender value and death benefit. Withdrawals may be subject to taxation within the first 15 years of the contract. You should consult your tax advisor when considering taking a policy loan or withdrawal.

The policy design you choose may impact the tax status of your policy. If you pay too much premium, your policy could become a modified endowment contract (MEC). Distributions from a MEC may be taxable, and if the taxpayer is under the age of 59½, may also be subject to an additional 10% penalty tax.

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