IRA Maximization

WHAT IS IRA MAXIMIZATION?

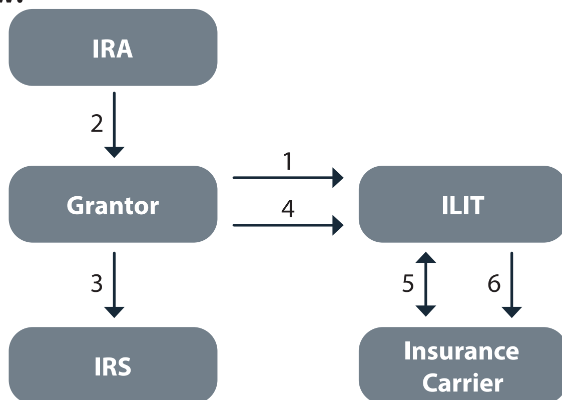
IRAs/qualified plans are extremely efficient vehicles when saving for retirement — the accounts grow tax deferred, allowing the accumulation of substantial assets that can be used to fund a retirement. However, while they are a great way to accumulate money, they're an extraordinarily inefficient way to transfer an inheritance. All of that tax-deferred growth comes due and is often coupled with estate taxes. Affluent individuals who have accumulated significant IRA/qualified plan accounts that aren't needed for retirement income may plan on leaving those assets to their children/grandchildren, unaware of the impact potential taxes could have on those assets. In fact, their heirs could see a reduction in value, due to taxes, of 70 – 85 percent of the account balance.

The overall goal of planning with IRAs/qualified plans is to maximize their accumulation efficiencies while minimizing their transfer tax inefficiencies. IRA maximization leverages funds accumulated inside of an IRA/qualified plan to fund life insurance owned outside of the taxable estate, potentially increasing the amount transferred to heirs.

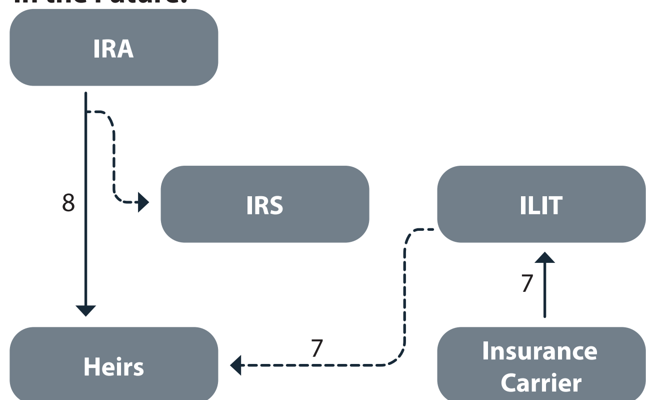
HOW DOES IT WORK?

The IRA/qualified plan owner takes income from the IRA/qualified plan by taking the required withdrawals (or an additional amount). Income tax is paid on the withdrawals, and the after-tax proceeds are then gifted to an irrevocable life insurance trust (ILIT) to fund a life insurance policy. The ILIT will receive a tax-free death benefit upon the death of the insured(s).

Now:



In the Future:



1. Grantor creates an ILIT.
2. Grantor receives distributions from IRA.
3. Grantor pays income taxes on IRA distributions.
4. Grantor gifts after-tax proceeds to ILIT.
5. ILIT applies for life insurance on the life of the grantor(s).
6. ILIT pays annual premiums to insurance carrier.
7. At death of the insured(s), ILIT receives life insurance death benefit estate and income tax-free for the benefit of heirs.
8. IRA is includable in the taxable estate of the account owner at death and is potentially subject to estate and income taxes.

ADVANTAGES

- **Potential Leverage –** Purchasing life insurance can potentially increase the amount left to heirs.
- **Income Tax Advantages –** In general, life insurance cash values grow on a tax-deferred basis, and the proceeds are received income-tax free.
- **Estate Tax Advantages –** If the life insurance is purchased in a properly drafted ILIT, the proceeds are generally received estate tax free.
- **Creditor Protection –** Depending on the state, life insurance can offer creditor protection.

DISADVANTAGES

- **Tax Implications –** Income taxes are incurred on withdrawals taken from the IRA/qualified plan.
- **Early Withdrawal Tax –** Where the owner is younger than age 59½, they must take substantially equal periodic payments to avoid the 10 percent early withdrawal penalty tax.
- **Impact on Plan Balance –** Withdrawals greater than the required minimum distribution (RMD) may reduce the overall value of the IRA/qualified plan.
- **Additional Costs –** Life insurance policies have charges associated with them, such as the cost of insurance and potential surrender charges.

THE BOTTOM LINE

IRA maximization converts a tax-inefficient IRA/qualified plan into a tax-efficient life insurance death benefit, potentially increasing the amount left to heirs.

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This is for general information only and is not intended to provide specific investment advice or recommendations for any individual. It is suggested that you consult your financial professional, attorney, or tax advisor with regard to your individual situation. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. If your policy is owned by a properly drafted trust that exists outside of your taxable estate, the income tax burden of the trust is reduced since the cash values grow tax-deferred. Moreover, the proceeds should not be subject to estate tax when the policy is owned by the trust.

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