When planning for your retirement, it's important to consider how your IRA assets will be used. (UBS)

Leaving more of your IRA assets with your family

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If you plan to leave Traditional IRA and 401(k) assets to your family, keep in mind that they will be taxed at ordinary income tax rates, which can significantly reduce the amount of after-tax wealth that they will receive as inheritance. By contrast, life insurance death benefits always pass income-tax-free to beneficiaries.

With this in mind, you may want to consider using your IRA—especially the Required Minimum Distributions (RMDs) that you don't need to fund your lifetime spending—to invest in life insurance for the benefit of your children and grandchildren. When you pass away, your life insurance death benefits can be used to offset the tax cost that your heirs will incur on their inherited IRA distributions. Life insurance can also help you to meet specific bequest objectives with greater certainty around the size of the gift.

If you and your family have philanthropic objectives, Traditional IRA and 401(k) assets can be a tax-efficient part of the solution. Qualified Charitable Distributions allow for tax-efficient lifetime gifts, and charities do not pay income taxes on bequests. By combining life insurance policies with charitable giving you can shift funds away from taxes and towards the intended beneficiaries of your inheritance and philanthropy objectives.

When it comes to determining how much life insurance you should purchase, families often take one of three approaches: Replace taxes, Eliminate taxes, or Maximize legacy. Each of these strategies can influence the amount of wealth that you can transfer to your family and charities using these three strategies (as opposed to doing nothing, and simply reinvesting your RMDs into a taxable account).

Here are additional details regarding each approach:

1. **Replace taxes** (cover the expected tax cost of IRA distributions for your beneficiaries): First, estimate the future value of your IRA assets when you pass away, and evaluate the tax rate that your beneficiaries will face on their distributions. Next, purchase a life insurance policy with a death benefit that covers the expected tax cost of the inherited IRA distributions. Pay for your life insurance policy using your RMDs, investing any excess funds in a taxable account. When you pass away, your heirs will receive the residual IRA assets, an income tax-free death benefit that covers the expected tax cost of IRA distributions, and a taxable investment account (with a step-up in cost basis that eliminates any unrealized capital gains).
2. **Eliminate taxes** (leave your residual IRA assets to charity): First, estimate the maximum value that your IRA will reach during your lifetime. In general, your IRA balance will continue to grow until your Required Minimum Distributions exceed the growth of your investments. For example, if your IRA's expected return is 7% per year, your IRA will most likely reach a peak value around the age of 88, after which your RMDs will require you to distribute more than 7% per year. Next, purchase a life insurance policy with a death benefit equal to your IRA's expected peak value. Last, designate a charity (or charities) to be the beneficiary of your residual IRA balance, and pay for your life insurance policy using your RMDs, investing any excess funds in a taxable account. When you pass away, your preferred charity will receive the residual IRA assets, while your heirs will receive an income tax-free death benefit equal to your expected peak IRA balance, and a taxable investment account (with a step-up in cost basis that eliminates any unrealized capital gains).
3. **Maximize legacy** (use your IRA's growth to buy life insurance, and leave your residual IRA assets to charity): First, estimate the expected annual growth rate of your IRA, and estimate how much will be left after being taxed on the distribution. For example, a $1 million IRA that generates a 7% annual return will create about $70,000 per year of growth; assuming a tax rate of 50.3% tax rate (37%federal income tax plus 13.3% California state income tax), that leaves about $34,790 of after-tax growth per year. Next, purchase the largest life insurance policy that you can afford with the expected after-tax growth of your IRA, using IRA distributions to pay the annual life insurance premiums and investing any excess funds in a taxable account. Last, designate a charity (or charities) to be the beneficiary of your residual IRA balance. When you pass away, your preferred charity will receive the residual IRA assets, while your heirs will receive an income tax-free death benefit, as well as a taxable investment account (with a step-up in cost basis that eliminates any unrealized capital gains).

Which approach should I implement?

When you pass away, there are three possible destinations for the wealth that you leave behind: your heirs, the government, or charity. When implemented properly, these strategies can help you to lighten the tax burden that your heirs will face on their inheritance and to move more of your wealth from the government into the hands of the charities that you want to support.

The right approach for you will depend on several factors including your wealth transfer objectives, your estate plan, your state's laws and tax policies, the size of your IRA, and the type of insurance you're able to purchase, to name a few.

We recommend discussing these options with your financial advisor. If you expect to have a taxable estate, you may want to consider one additional step: purchasing life insurance within an Irrevocable Life Insurance Trust (ILIT). Because the ILIT exists outside your taxable estate, the policy's death benefit will not be subject to estate taxes when you pass away. Moreover, trusts can allow to you to maintain some level of control over how and when the death benefit will be distributed to your beneficiaries after you pass.

Before implementing any changes, it's important that you also connect with your estate attorney and a life insurance agent who will be able to help you determine the appropriate amount of life insurance to purchase.

For important details and considerations regarding ILITs, please see the **Life insurance** report from UBS's Advanced Planning Group.

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Important information

Additional Information

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