Fund an IRA conversion with life insurance

SECURE Act promises new life insurance opportunities

Aimed at increasing access to tax-advantaged accounts and preventing older Americans from outliving their assets, the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) is far-reaching retirement savings legislation that took effect in January 2020.

One significant provision eliminated stretch IRAs as an estate planning tool by requiring full distribution of an IRA to certain beneficiaries within 10 years, following the year of the employee or IRA owner's death.

Now is the time for you to talk to your financial professional about your estate plans and discuss new options to help you pass your legacy to your beneficiaries without also passing a big tax bill.

Minimize taxes with an IRA conversion

The passage of the SECURE Act brought many positives to the retirement landscape, but the requirement for most beneficiaries to take the full distribution of an inherited IRA within 10 years could result in a higher-than-expected tax bill for beneficiaries. With federal income tax rates at a low due to the Tax Cuts and Jobs Act (TCJA) of 2017, converting a traditional IRA to a Roth IRA may be a useful strategy to minimize taxes.

Roth IRAs allow you to grow savings tax-free and take tax-free withdrawals in retirement without required minimum distributions (RMDs), as long as you have owned your account for five years. Because conversion is treated as a taxable distribution from your traditional IRA, however, it will trigger a bigger tax bill in the year it is converted. Using a life insurance policy to help fund the conversion can help with the tax issues and provide additional benefits to beneficiaries.

Considerations

Converting a traditional IRA to Roth status will NOT trigger the 10% penalty tax distributions if the conversion occurs before the participant turns 59½. After conversion, if the participant dies, beneficiaries of a Roth IRA are still subject to the 10-year payout rule; however, the payouts will be income tax-free.

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Strategies to convert to a Roth IRA

1. **Full conversion.** The participant purchases a life insurance policy and leaves it to the beneficiary of the IRA. If the participant is age 59½ or older, they can use distributions to pay premiums. When the participant dies, the entire remaining balance of the IRA is converted to a Roth, and the life insurance proceeds help pay the income tax that is due at the conversion time. It must be a qualified direct rollover.
2. **Rolling conversion.** The participant can convert a portion of their IRA to a Roth IRA each year. Each conversion will incur an income tax liability. The participant purchases life insurance and withdraws from the cash value during their lifetime to pay the tax.[1] If the participant dies before full conversion, the death benefit is used to pay tax on any remaining balance that is converted to the Roth. It must be a qualified direct rollover.
3. **Conversion at death.** A key strategy would be to convert in the year the participant dies. After the conversion, all payments to the beneficiary would be income tax-free. Because the IRS has determined that inherited IRAs are not qualified rollovers, a beneficiary cannot convert them to a Roth IRA unless there is a named beneficiary. While an inherited IRA cannot be converted to a Roth, the beneficiary can make a qualified direct rollover to a new IRA.

A **qualified direct rollover** to a new IRA is also known as a trustee to trustee transfer. See IR Notice 2007-07 for more details on how this is done.

How the strategy works

Meet Ben

Age 50, IRA owner

Ben does not need his IRA as a financial resource and would like to leave his savings to his nephew Peter.

His financial professional recommends converting his traditional IRA to a Roth IRA funded by a life insurance policy to pass his inheritance income tax-free.

Advantages for Ben

- He can take advantage of the current low tax rate
- His Roth IRA will grow tax-deferred, and if he needs an income source, qualified distributions will be tax-free

Advantages for Peter

- Peter will be subject to the 10-year withdrawal requirement; however, it will be income tax-free
- If Ben dies before he fully converts his traditional IRA, the death benefit of the life insurance policy can pay the income taxes to finish the conversion

When funded with a life insurance policy, converting a traditional IRA to a Roth IRA can be a good strategy to help minimize taxes and provide additional benefits to beneficiaries.

[1] Loans and withdrawals reduce the policy's cash surrender value and death benefit, may cause the policy to lapse, and may have tax implications.

Contact your Lincoln representative to run an illustration on this concept.

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