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3 Ways Life Insurance Can Help Your Estate Plan

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I recently read an article about a financial advisor who met a 60-year-old client who's single with a pension income and over $1 million in IRAs. This client's goal is to convert his IRA account to Roth IRAs, then pass them on to his children tax-free. The advisor recommended he convert $100,000 each year over the next 10 years. This will help him avoid required minimum distributions (RMDs) after age 70 ½, and delay his Social Security benefits to age 70, thereby getting the maximum benefits. By doing this, the income taxes owed each year for the conversion tax would be about $35,000, which could be more or less, depending on state income tax rates. The client accepted the idea and has started the conversions.

Although he can achieve his goal this way, I believe he had a better option.

What if the advisor had sold him a $1 million life insurance policy instead? With a 10-pay premium (depending on health risk) of the same $35,000 year, the client would have 100% of the IRAs, and has the potential to grow in value. Even though he must withdraw RMDs from a now-growing account, he can switch his beneficiary to a charitable trust. Upon his passing, his children can receive the life insurance, tax-exempt, just like the Roth IRA, and charities get 100% of the future value, also tax-exempt!

With the fact that the IRA is giving income from the RMDs, it may also be added, after tax, to the life insurance policy. If this happens, it's even possible that the death benefits could grow in the future, giving a cost-of-living benefit to his children.

This is one of the several ways life insurance can be used in a creative way to help your estate plan. In this article, we'll cover three ways life insurance can better help your loved ones once you're gone.

Paying taxes

In the 1990s, it was common for people to purchase second-to-die life insurance policies to help pay federal estate taxes. Today, in 2019, with estate tax exclusions up to $11,400,000 (and rising with the cost-of-living adjustments), fewer and fewer people would owe much for estate taxes. But what about the IRAs, 401(k)s, etc.? They are still 100% taxable to the individuals, spouses, and their children. While stretch IRA options still exist, they may go away someday. In fact, at the time of this article, Congress is looking to limit stretch IRAs to a maximum of 10 years.

Even today, Oregon is 9% above $1 million and Washington State is just over $2 million, at 10%. Life insurance can be used to pay the taxes at the second death, as it provides liquid, tax-exempt money when needed most to pay off the debt to the state and not force families to sell assets when it may not be in the best of times. Also, as life insurance money is paid immediately after death, it gives tax-exempt money to the family.

Regardless, income taxes are here to stay when it comes to qualified retirement accounts, so planning is vital.

Spouse benefits

For married couples, one approach is to consider how life insurance on the individual could be used to pay "conversion tax" at death using tax-free benefits. Once the retiree dies, the spouse beneficiary can then convert all the IRA (taxable money) to a Roth IRA, which is tax-exempt with new, lower income tax rates (37% 2018-2025 versus 39.6% 2017 or earlier). The tax-free death benefit money can pay the taxes on the conversion, allowing the surviving beneficiary to then enjoy a lifetime of tax-exempt income without required minimum distribution issues from the Roth IRA. The SSI could possibly be tax-exempt as well, as Roth withdrawals do not count as "income" in the equation for determining how much of your Social Security is taxed. You would, however, have to be within the threshold for any other combined income, with more information at the Social Security Administration's website. In my opinion, life insurance for both individuals (if married) would be ideal; if the spouse of the IRA owner died, the money from the life insurance can be used once again. If this is done in the tax year of the death for married individuals, the tax conversion could be done under "married filing status" before the next year, when the individual moves to single tax filing status.

Passing on a legacy

Another benefit of the IRA-to-Roth conversion is the passing of Roth IRAs to heirs, which could create a lasting legacy if planned out correctly. New life insurance policies that add long-term care features with chronic care and critical care benefits can also add an additional layer of benefits, if one of the insureds has health issues before death.

It's critical to monitor tax rates and possible changes. Given today's lower tax rates, this could be very beneficial. Keep in mind the individual state taxes, as well. But considering all the tax-optimized benefits to spouses and beneficiaries, the long-term tax benefits outweigh the lifetime tax liabilities, especially when you consider SSI tax benefits as well for the surviving spouse and no RMD issues.

As people decide what they should do to benefit their spouses and families, considering life insurance in retirement can help protect, build, and transfer wealth in one of the simplest ways possible. If you're unsure of where to start with your life insurance needs, speak with a seasoned financial professional today to get started!