3 Reasons to Replace the Stretch IRA with Life Insurance

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Now is the time to help clients plan to replace the stretch IRA with something even better — *life insurance*.

No one is a bigger fan of the so called "stretch IRA" than me. I've been touting its benefits for over 20 years. The stretch IRA is a term that describes how an inherited IRA can be extended ("stretched") over the lifetime of an individual IRA beneficiary if the IRA was set up properly and the beneficiary knows what to do after death. But the stretch IRA may be on the chopping block. Congress is constantly looking for new revenue and may soon replace the stretch IRA with a 5-year rule: Instead of extending distributions from inherited IRAs over a beneficiary's lifetime, the beneficiary will have to withdraw the entire inherited IRA by the end of the 5th year after the year of the IRA owner's death. This will diminish the long-term benefits of leaving an IRA or a Roth IRA to beneficiaries.

Now is the time to help clients plan to replace the stretch IRA with something even better — *life insurance*. Life insurance has three huge advantages over the stretch IRA:

1. **Life insurance distributions to beneficiaries are tax-free.** Though an inherited IRA can be stretched, the distributions will generally be taxable. Though inherited Roth IRA distributions will generally be tax-free to beneficiaries, the Roth IRA is paid for using funds that could be better leveraged for life insurance instead. Taking taxes out of the picture gives beneficiaries more leeway with distributions.

2. **Life insurance is not subject to required minimum distribution (RMD) rules.** Inherited IRAs are subject to RMDs (whether the beneficiary needs the funds or not), forcing distributions out of the inherited tax-sheltered account. In addition, calculating RMDs on inherited IRAs can be challenging for beneficiaries and can result in penalties if the right RMD is not taken.

3. **Life insurance is not buried with complicated tax rules.** Inherited IRAs are subject to confusing and tricky tax rules that make it more likely that an IRA beneficiary will blow the stretch IRA and end up with a tax problem instead.

Moving inherited IRA funds incorrectly can cause the account to be taxable because a non-spouse IRA beneficiary cannot do a rollover, but most beneficiaries do not know this. Inherited IRA funds cannot be rolled over into a beneficiary's own IRA. That would be treated as a distribution triggering premature income taxes and ending the inherited IRA. Beneficiaries are generally not aware of these tax traps until it is too late.

There are also special tax rules for inherited IRAs that depend on who the beneficiary is. There are rules that apply to a spouse and those that apply to a non-spouse beneficiary. That creates different planning scenarios, which can lead to more tax mistakes if the rules are not followed precisely.

If clients want to ensure an inherited IRA is not squandered by beneficiaries, they would usually have to set up a trust and make that trust the IRA beneficiary and include restrictive provisions. But this is expensive to set up; and many of these trusts backfire because they don't adhere to the tax rules that apply when an IRA is left to a trust. Even if the trust is done perfectly, it still can result in ultra-high taxes on the IRA distributions that end up being taxed in the trust.

Life insurance can also be left to a trust. But since the distributions are tax-free, and there are no complicated IRA-specific trust tax rules, the insurance can be distributed to the beneficiaries or remain in the trust for their benefit according to the client's wishes, without having to deal with the complexities and expense of creating a trust as the IRA beneficiary. Life insurance is a better, more efficient post-death planning vehicle than an inherited IRA.

Begin the transition from IRAs to Life Insurance. For IRA clients who want to pass as much as possible to their heirs (and they do not need the IRA funds for themselves), advisors should start changing the strategy and begin replacing the stretch IRA with life insurance.

It pays to draw down IRA funds (even if the client is under age 70 ½ and not required to take RMDs), pay the tax at today's low rates, and then use those funds to purchase life insurance.

Beneficiaries will most likely end up with more than they would have inherited from the IRA, and without all the tax rules to comply with. Best of all, the life insurance proceeds will be tax free.

If a client intends to leave as much of his or her IRA as possible to his beneficiaries to provide a stretch IRA legacy, they should look at life insurance instead — starting now. Start replacing the stretch IRA with life insurance to gain current and future tax and estate planning benefits.