HOLLY BURGESS

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Wealth Transfer For Middle-Income Retirees

Picture This…

Mary, age 71, retired a few years back with a nice nest egg. Between her company pension, Social Security, and some other modest assets, she lives comfortably. In fact, her retirement lifestyle is so well defined by years of frugal living that she doesn't even need, or intend to use, her $100,000 IRA for retirement income. However, she prefers to keep the IRA principal intact, just in case of a rainy day. Anything remaining in the IRA at her death will pass to her church.

Do you know someone like Mary? Now that Mary has passed age 70 1/2, the government *requires* her to take taxable required minimum distributions (RMD) from her IRA. At age 71, Mary's RMD is $3,953 (pre-tax), based upon the IRS's 2001 regulations. Mary intends to reinvest those distributions—after paying income taxes—in an account that her son will receive upon her death. Assuming Mary's life expectancy is 13 years—to the year 2014—Chart 1 illustrates how the reinvested after-tax distributions would grow over time.

Assuming Mary died in 2014, her son would inherit $74,405. Of course, this also assumes that Mary paid the annual income taxes out of pocket on the earnings generated by the reinvested distributions.

Chart 1

Year	Gross RMD	RMD After Taxes (28% Tax Rate)	Reinvested RMD (Earning 6%)
2001	$3,953	$2,846	$ 2,846
2005	4,931	3,550	17,307
2010	6,419	4,622	44,074
2014	7,759	5,586	74,405

What's Wrong with this Picture?

Mary doesn't realize there's a better option. With a slightly different approach she can still benefit her son and even *increase his inheritance.* Mary would be well advised to apply for life insurance on her life using the RMD money to pay the annual premiums. In this case, the annual stream of after-tax distributions would purchase a level $100,000 universal life insurance death benefit. This assumes that Mary is in good health (a preferred risk class), does not use tobacco products, and the insurance contract is crediting the same six percent as the reinvested funds.

If Mary passed away in 2005, the life insurance increases her son's legacy by over 577 percent. But, realistically, Mary expects to live to a ripe old age. If she reaches her life expectancy, the legacy is still 34 percent greater through life insurance versus reinvesting.

What If Mary Is Willing To Invade the IRA Principal?

Mary may not want to lock into annual payments for her life insurance. An alternative approach is to simply reposition a single lump sum distribution greater than the RMD amount. After age 70 1/2 Mary has the unfettered right to take as much as she wants from her IRA without any penalty. Her only costs are the income taxes due on the IRA.

Let's assume Mary takes a single $50,000 distribution from the IRA. After paying taxes, she uses the remaining $36,000 to fund a single premium universal life insurance policy. Her immediate guaranteed minimum death benefit in year one could be $58,568—an income tax free legacy to her son. By age 84, the non-guaranteed death benefit would have increased to $78,000 based upon a six percent crediting rate.

Chart 2

Year of Death	Gross Inheritance	Net to Heirs	Net to Son as Percentage of Total
2001	$104,893	$76,320	72.760%
2005	126,315	95,793	75.836
2010	157,415	125,680	79.840
2014	185,901	154,682	83.207

By introducing life insurance we dramatically improve the son's situation. Using the stream of after-tax RMD, we fund a $100,000 universal life insurance policy. The result is:

Year of Death	Gross Inheritance	Net to Son	Net to Son as Percentage of Total
2001	$202,047	$173,474	169.994%
2005	209,008	178,486	163.736
2010	213,341	181,606	160.229
2014	210,107	180,279	161.689

Do the Results Change If Mary Intends to Leave All of the IRA to Her Son?

The results would still favor the life insurance. The combination of tax deferred growth and *income tax free death benefit* give the life insurance financial leverage superior to the IRA. That's because any money received from the IRA—whether taken by Mary or by her son—will be subject to income taxes (and possible estate taxes if the owner is sufficiently wealthy).

Let's consider Mary's situation. Assume she passes away in any of the years listed in Chart 2, leaving her IRA to her son. The gross inheritance represents the IRA pre-tax value, including the required minimum distributions that have been reinvested for the benefit of the heir. The net to heirs is the amount that Mary's son would receive after income taxes are paid. Note that her son will only receive 72 to 83 percent of the total value of the IRA and reinvested required minimum distributions.

In any given year, Mary's son would receive almost double the inheritance by simply diverting the RMD to fund the life insurance policy as opposed to reinvesting the RMD.

Repositioning Retirement Plan Distributions Makes Sense

All scenarios point to repositioning RMD to fund life insurance. Whether Mary commits to annual premium payments from her RMD or opts for a single distribution, she has immediately provided a significantly larger, more secure legacy for her son. And that's a good feeling because there's no time limit on a parent's desire to provide for offspring. Life insurance can do just that! ❑