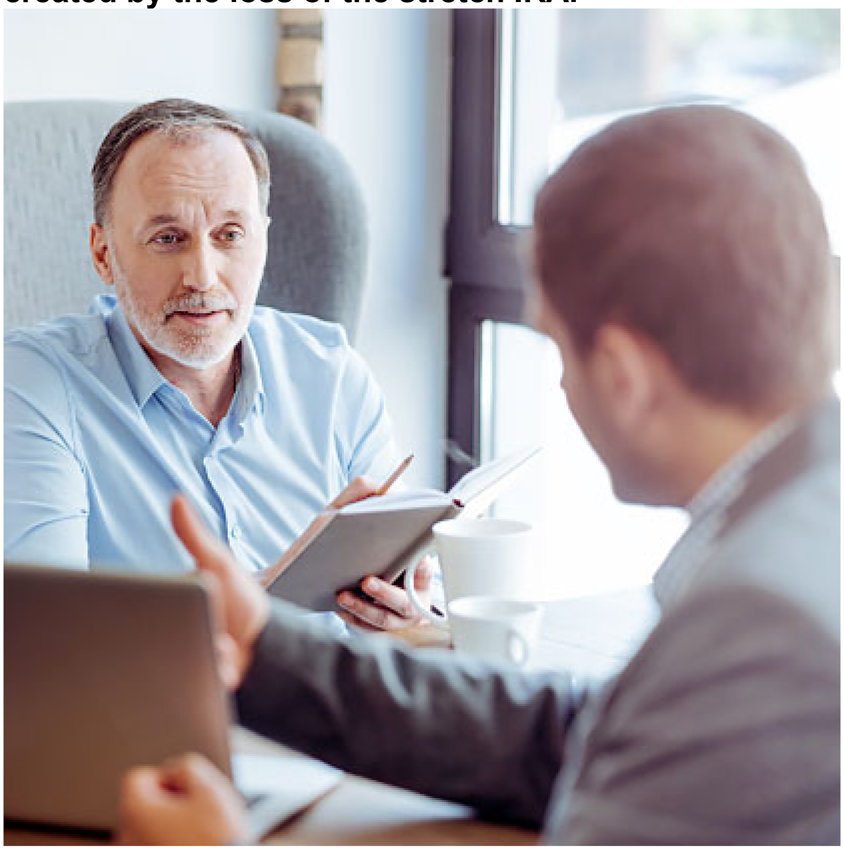
Rethinking Life Insurance: 3 Reasons Your Client Might Need It Again Under the SECURE Act

Oct 12, 2020 / **By Debra Taylor, CPA/PFS, JD, CDFA**

While it has fallen out of favor over the last decade, life insurance can make sense again for those who want to offset the SECURE Act's tax blow to heirs created by the loss of the stretch IRA.



During the last 10 years, many advisors and clients have been talking about life insurance less and less, and for good reason. We have seen an 11-year bull market that has increased portfolios for many households and created a profound wealth effect (even in spite of recent market volatility). Indeed, there is over $20 trillion sitting in employer retirement plans and in IRAs, about evenly split between the two. Fidelity has recently reported a record-breaking 208,000 millionaires with IRA plans. You get the picture.

At the same time, the lifetime estate tax exemption has kept increasing. The Tax Cuts and Jobs Act of 2017 doubled the lifetime exemption in 2018 from $5,450,000 to $11,400,000, effectively allowing lots more wealth to be transferred to the next generation without paying taxes. And then there is portability (the ability to transfer the amount of the unused lifetime estate exemption to the surviving spouse), which was introduced and then made a permanent part of federal estate tax law in 2013.

As if that were not enough, the exemption is also adjusted annually for inflation, which means that the exemption is currently $11,580,000 and $23,160,000 (when including portability). In short, the lifetime annual exclusion has increased 113% during the last six years (from $5,430,000 for singles in 2015).

The generous and ever-increasing estate tax exemption ensures that only about 2,000 families will pay any federal estate taxes in 2020. As a result, most high-net-worth households are no longer concerned with the estate tax. Therefore, there is less need for life insurance for most families, except in very specific instances.

Life insurance can still make sense for those who are very poor or in the wealth accumulation phase, such as young families who cannot self-insure and are looking for wealth replacement. Term insurance can be a low cost and effective option here. Obviously, life insurance also is critical for those families who are worth close to or over $23,000,000, and/or those with large family businesses. For those extremely high-net-worth families, universal life insurance should be considered as a solution.

In summary, life insurance only makes sense for the very poor, wealth accumulators who still have a way to go, or the very rich. As a result of the 11-year bull market and the exponentially growing lifetime exclusion, life insurance has lost its place as a critical piece of most clients' financial plans. In fact, the share of Americans with life insurance has declined by 17% in the last 28 years.

The passage of the SECURE (or, as you will recall, the Setting Every Community Up for Retirement Enhancement) Act in December of 2019 changed all of that. Despite its billing as legislation designed to aid middle class families who are saving for retirement, the SECURE Act benefits the life insurance industry first and foremost.

You are undoubtedly familiar with the most basic provisions of The SECURE Act; however, the biggest game changer is your clients' inability to transfer their traditional IRA accounts to the next generation without adverse tax effects. As a result, for better or worse, it is time for all advisors to change their approach and embrace life insurance once again as a critical estate planning tool.

The SECURE Act eradicates "stretch IRAs" which previously allowed nonspouse IRA and retirement plan beneficiaries to drain inherited accounts over their life expectancy. Now, those same beneficiaries have only 10 years after the account owner's death.

By eliminating stretch IRAs, the SECURE Act essentially creates an estate tax on large IRA transfers at the time of death, with up to 50% of the IRA going to federal (and possibly state) income taxes if proper planning is not done. Obviously, there are options to prevent the large tax bill. However, some people cannot effectively do Roth conversions because it is too late or their income is too high or the traditional IRA balance is too large. This is precisely where life insurance may play a role.

These people should consider buying life insurance with discretionary income (or with their RMD money) in order to offset the blow to their heirs from highly taxed IRAs. Keep reading to discover the three reasons that your client might need life insurance under the SECURE Act to provide a tax-advantaged future for their heirs.

1. Life insurance gives flexibility to transfer of large IRAs

Life insurance is important for many reasons in the SECURE Act world, but chief among them is flexibility. The SECURE Act imposes strict distribution rules on nonspouse heirs, namely the 10-year withdrawal period. Most notably for our purposes, this 10-year period also applies to conduit trusts, as well.

Because this 10-year distribution regime is imposed on conduit trusts, clients with large IRAs may be left struggling with how to pass assets to their heirs in a most tax-advantaged way. They also may still be looking for a way to leave assets to children while still imposing some structure or guidelines. And clients may still want to include a trustee to oversee the transfer of the large IRA. However, under the SECURE Act, placing the IRA into a conduit trust deprives the trustee of her discretion and forces payments by the tenth year (and therefore also creates a disastrous tax bill by or in the tenth year).

Life insurance can help with that conundrum. If life insurance is placed in an irrevocable life insurance trust, or ILIT, the flexibility is returned to the clients and the discretion is also restored to the trustee. The life insurance not only restores flexibility but it also avoids the disastrous tax implications of the 10-year rule as the life insurance proceeds can be paid income and estate tax-free over a variety of time horizons.

2. Lifetime payments are available with life insurance trusts

Another large benefit of life insurance and ILITs are the ability to create lifetime income, just as was once available under a stretch IRA placed in a Conduit Trust. More specifically, as the proceeds of a life insurance policy are held in trust for the beneficiaries, those beneficiaries could receive regular incremental payments or even discretionary payments over an extended period of time, rather than receiving all monies by (or in) year 10.

For many clients with substantial traditional IRAs, this is a preferred result. However, if you die within three years of transferring your life insurance policy to the ILIT, the IRS will still include the proceeds in your estate for tax purposes. Consequently, proper advanced planning is required and very last minute tax avoidance maneuvers are not recommended.

3. Another thought: Use the life insurance to pay that tax bill

Although taxes may be a constant in life, what beneficiary is prepared to be pushed into a higher tax bracket for the next 10 years and to pay this crazy tax bill coming due as a result of the SECURE Act? This is where life insurance proceeds can come in handy, since they can be used by beneficiaries to pay their tax bills on that large IRA. Instead of performing Roth conversions and engaging in unnatural acts to lessen the tax bill down the road, perhaps your client should buy a $2.5M life insurance policy on that $5M traditional IRA. Keep it simple!

And don't forget, the expanded lifetime exemption is due to sunset in 2026, at which time it will revert back to the 2017 exclusion amount (adjusted for inflation). If this happens, then life insurance will once again be a saving grace for those clients who were well advised as it will provide some certainty in a very uncertain world.

Case study

On a final note, it is easy to talk about buying life insurance, but it is important to understand how life insurance checks out in real-life scenarios. WealthManagement broke down the numbers with a case study that demonstrates how life insurance can replace the deferral benefits lost due to the SECURE Act.

In this case study, Lily is a 60-year-old widow with $5M in an IRA account that she inherited from her deceased husband, $4M in a nonqualified plan, and $6M in outside investments. Lily wants her IRA to pass to Harry, her 30-year-old son, upon her death. Before the SECURE Act, Harry could have had 30+ years of payments spread over his life expectancy with the investment returns on the funds in the IRA protected from income taxes. Unfortunately, the SECURE Act removed IRA stretch provisions in this instance, which hurts the potential growth balance of the IRA tremendously, and results in a projected loss of growth of over $19M.

Old Law versus changes from the SECURE Act			
Before SECURE Act 6% growth of balance over lifetime		**With SECURE Act 6% growth of balance over 10 years**	
Beginning Balance of inherited IRA	$9,000,000	Beginning Balance of inherited IRA	$9,000,000
RMDs over Son's lifetime	$48,000,000	Required Distribution Year 10:	$16,000,000
Tax on distributions:	(19,000,000)	Tax on Distribution:	(6,000,000)
Net Amount to Son:	**$29,000,000**	Net Amount to Son:	**$10,000,000**

Source: WealthManagement.com

Thankfully, Lily can buy life insurance to help regain that lost capital. Moreover, if Lily and her husband had bought a second-to-die life insurance policy, that would have been even cheaper. As life insurance proceeds are paid income tax-free to the beneficiary, Lily can use an ILIT to keep the proceeds out of her estate for transfer tax purposes and Harry will receive the death benefit.

According to WealthManagement, Lily should buy a $12M life insurance policy and she can pay for the premiums on the policy through RMDs from her qualified plans over 10 years (and use her annual exclusion and unified credit to avoid gift taxes when she pays the premiums). Assuming Lily dies after 10 years, Harry will receive the death benefit without a tax obligation. As a result, Harry's net amount quadruples from $5M (with no planning) to $20M (with planning and delaying distribution from the IRAs for 10 years to maximize tax-deferral) and allows him financial flexibility.

Option 1 IRA Balance - Lump Sum Distribution			
No Planning		**With Planning Death Benefit Proceeds Received as a Lump Sum**	
		Death Benefit Proceeds:	$12,000,000
IRA Account Balance at Death:	$9,000,000	IRA Account Balance at Death:	2,000,000
Tax on Lump Sum Distribution:	(4,000,000)	Tax on Lump Sum Distribution:	(1,000,000)
Net Amount to Son:	**$5,000,000**	Net Amount to Son:	**$13,000,000**

Option 2: IRA Balance - Delay Distribution for 10 Years to Maximize Tax-Deferral			
No Planning		**With Planning Death Benefit Proceeds Received as a Lump Sum**	
		Death Benefit Proceeds:	$12,000,000
		Value of Proceeds after 10 Years (3.6%) (A):	17,000,000
IRA Account Balance at Death:	*$9,000,000*	IRA Account Balance at Death:	2,000,000
IRA Balance After 10 Years (A):	16,000,000	IRA Balance After 10 Years (B):	4,000,000
Tax on Lump Sum Distribution(B):	(6,000,000)	Tax on Lump Sum Distribution(C):	(1,000,000)
Net Amount to Son (A)+(B):	**$10,000,000**	Net Amount to Son (A)+(B)+(C):	**$20,000,000**

Source: WealthManagement.com

Of course, you need to take into account that there are life insurance premiums and clients need to go through underwriting (another reason that planning needs to be done well in advance, when possible).

In conclusion, life insurance is no longer just for the ultra-low- or ultra-high-net-worth. Thanks to the SECURE Act, life insurance should be back on the table as an option to help individuals with large IRAs increase wealth and decrease the tax burden on future generations. Deficit spending, income inequality, decreased tax revenues, and the upcoming presidential election are all putting the estate tax back onto the front burner, and once again, life insurance may be a near-necessity to pay estate taxes if the lifetime exclusion is reduced, as some are arguing for.