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Use Of Roth IRAs And Survivorship Insurance After The SECURE Act

MARCH 20, 2020 • **JAMES G. BLASE**

From a pre- and post-death income tax planning perspective, the SECURE Act is all about tax brackets. If left unaddressed by clients and their advisors, the result of the new law will likely be that the clients' children will be forced to pay income tax on the clients' IRA balances at death over a maximum of 10 years—years in which the children are likely to already be in their peak tax brackets, e.g., ages 55 to 65. The recommendations below apply to clients who do not plan to live off of their IRAs when they are retired, i.e., who would otherwise only take the minimum withdrawals from their IRAs which the law requires them to take.

The general recommendation for this category of clients, once they retire (i.e., and are now in a low tax bracket), is for them to begin to "milk out" their IRA balances rather than wait until age 72 to begin withdrawing their balances, and then only withdraw the minimum required amounts each year—amounts which are typically very small until the clients attain approximately age 85. An idea which can minimize overall tax brackets for these clients and their children is to, in effect, amortize the IRAs over the lifetimes of the clients, plus 10 years thereafter (i.e., the children's maximum deferral period).

Take, for example, a recently retired couple ages 62 for the husband and 59 for the wife, who estimate their joint life expectancy to be 30 years. They then add 10 years onto this (for the distribution period of their children, under the SECURE Act), and attempt to amortize their IRAs equally over an approximate 40-year period.

Assume the couple's combined IRAs are worth $1,300,000. If the couple amortized this amount over 40 years, at a 5% interest rate, their annual withdrawals, as well as the total annual withdrawals of their children, would be approximately $75,000, which would keep the couple in the 12% tax bracket (under current law), even with other miscellaneous income included and, more importantly, would minimize the income tax brackets of their children.

The above tax benefits being rather obvious, the decision next becomes how to invest the $75,000 annual withdrawal. Prior to age 72, the couple could roll this entire annual amount into a Roth IRA. After attaining age 72, however, only the portion of the IRA withdrawal that exceeds the couple's required minimum distributions for the year can be converted into a Roth IRA.

For purposes of this analysis, we will assume the couple can roll the entire annual amount into a Roth IRA over their remaining 30-year combined life expectancy and/or invest it in assets, which will produce no annual income, only appreciation, e.g., a non-dividend paying equity portfolio and/or tax-exempt bonds. After 30 years, compounded at a 5% rate of return, the $75,000 annual contributions would grow to $5,232,059. If either the husband or wife lives five years beyond their anticipated life expectancy, i.e., until age 97 for the husband and/or 94 for the wife, the $75,000 annual contributions would grow to approximately $7 million, again, all tax-free.

The couple's option would be to invest the $75,000 annual amount in income tax-free second-to-die life insurance, or one life insurance policy that does not pay out until both spouses die, and is therefore considerably less expensive than a policy on either spouse's life alone. Assuming the couple is in preferred health, the guaranteed income tax-free death benefit would be approximately $7 million.

The differences between the "Roth IRA investment plan" and the "second-to-die life insurance" investment plan are the following:

1. The Roth IRA investment plan is not guaranteed to produce the above-outlined tax-free results, which may be relevant to the couple in an unstable stock market.

2. Second-to-die life insurance is guaranteed, and obviously produces an income tax-free windfall for the children if the parents should die before the expiration of the 35 years. This windfall can then be utilized by the children to help pay the increased income taxes on the larger IRA receipts as a result of their not having been withdrawn during the couple's lifetime. This represents an advantage of the second-to-die life insurance plan over the Roth IRA plan, i.e., in the event the couple should pass earlier than anticipated.

3. Unlike a Roth IRA, the cash value of the second-to-die policy will be small or non-existent if the goal is to maximize the income tax-free death benefit to the children, so clients who feel they may need to access a significant portion of the policy's cash surrender value during their lifetime will generally want to utilize a second-to-die life insurance policy with a smaller death benefit amount and a larger lifetime cash surrender value.

4. If the couple outlives the longer 35-year joint life expectancy referred to above, the Roth IRA approach would have then been preferable, in hindsight, assuming the 5% lifetime rate of return is achieved.

The couple could obviously choose to hedge their bets and invest some of the $75,000 annual amount in a Roth IRA and some of it in second-to-die life insurance. The key point is that, either way, what the retired couple has accomplished by this plan is to minimize the effects of the potentially very high income tax brackets of their children (because likely the IRA balance will need to be paid out during the children's peak earnings years) by "milking out" their IRA balances over their joint lifetime, at low tax rates, and transferring the withdrawn funds into a tax-free vehicle producing a reasonable rate of return.

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