Replicating stretch IRA benefits with a life insurance policy

SECURE Act promises new life insurance opportunities

Aimed at increasing access to tax-advantaged accounts and preventing older Americans from outliving their assets, the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) is far-reaching retirement savings legislation that took effect in January.

One significant provision eliminated stretch IRAs as an estate planning tool by requiring full distribution of an IRA to certain beneficiaries within 10 years, following the year of the employee or IRA owner's death.

Now is the time to talk with your financial professional about estate plans and discuss new options to help pass along a legacy to beneficiaries without also passing a big tax bill.

Replicating a Stretch IRA with life insurance

Before the passage of the recent SECURE Act, beneficiaries of an IRA could stretch their payments over their lifetime, extending the benefit of the tax deferral. With the new 10-year payout requirement, distributions could result in a higher-than-expected tax bill for the beneficiary. Using life insurance to replicate a stretch IRA may be a good option to help you minimize the tax effects of this new bill.

In lieu of leaving the IRA beneficiary to receive the 10-year stretch payment, the IRA owner can take lifetime IRA distributions and use the payments to fund a life insurance policy. The life insurance policy can then pay stretch payments to the beneficiary from the cash value when the participant/insured is still alive, or out of the death benefit should the participant die.

Considerations

IRA distributions are subject to a 10% penalty tax on top of ordinary income tax when distributions occur before the participant attains age 59½. However, if the payments are "substantially equal periodic payments," under IRC 72(t)(4), the penalty does not apply.

Revenue Ruling 2002-62 provides three different methods for calculating substantially equal period payments.

1. Take required minimum distribution (RMD)-like payments using the RMD formulas.
2. Amortize the IRA balance, over the life expectancy of the participant, and use an interest rate not to exceed 120% of the federal mid-term rate [ITC 1274(d)].
3. Calculate an annuity-type payment using IRS annuity tables.

By using substantially equal periodic payments, the IRA owner can use penalty-free funds from the IRA to fund a life insurance policy, and the life insurance policy can provide payments to the beneficiary for more than 10 years. Because these payments can be tax-free, they may be higher than the payments would be if they were made simply by taking the money out of the IRA.

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How the strategy works

Meet Sid Smith

Age 50, IRA owner

Sid doesn't need his IRA as a financial resource and would like to leave his savings to his nephew Benny. Sid has learned about the SECURE Act's 10-year rule that applies to payouts from an inherited IRA. His financial professional recommends that he relocate a portion of the IRA to a life insurance policy.

1. Sid can take distributions from the IRA and fund a life policy on the beneficiary, using substantially equal periodic payments. Sid can do this at any age. He will have to report the distribution as ordinary income, but there is no 10% penalty.
2. Benny can use the policy's potential cash value to provide a tax-free income source.

Calculating the substantially equal periodic payments

RMD method: The annual distribution amount is determined by dividing the account balance as of December 31 of the prior year by the single-life expectancy obtained from the same single-life expectancy table using the age attained.

Amortization method: The annual payment for each year is determined by amortizing the account balance in level amounts, over a specified number of years, using the chosen life expectancy table and the chosen interest rate.

Annuity method: Divides the retiree's account balance by an annuity factor taken from IRS tables to determine an annual payment amount.

When structured properly, the relocation approach can result in significantly more tax-free income and flexibility than a simple stretch IRA.

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Reach out to your financial professional to learn more about this concept.

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LCN-5761216-062023
POD ADA 7/23 **Z03**
Order code: LIF-TAX-FLI018

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