IRA TAX BOMB

For most people, the tax-deferred traditional 401(k) and IRAs (individual retirement accounts) become their biggest assets through time. And while it is good to have a large nest egg, many do not understand the potential tax ramifications during retirement—or the potential tax burden for their heirs later—in the form of ordinary income taxes that may be due on required distributions and withdrawals from non-Roth accounts. Here are two of the potential TAX BOMBS that await!

Taxable 401(k)s and IRAs (individual retirement accounts)

While most investors consider their traditional, tax-deferred non-Roth 401(k) and IRA accounts the foundation for retirement, often when they reach age 59.5—when they are legally **allowed** to take withdrawals or distributions from their accounts—they defer and wait until they legally **must** take them and pay ordinary income tax on the amounts withdrawn.

IRS MANDATED RMD (REQUIRED MINIMUM DISTRIBUTION) DATES

RMD age by year

- **2023–2032:** RMD age is 73
- **2033 and later:** RMD age is 75

The RMD starting age depends on the year in which you were born:

- **1950 or earlier:** RMD starts at age 72
- **1951–1959:** RMD starts at age 73
- **1960 or later:** RMD starts at age 75

Ordinary income taxes are due to amounts withdrawn from non-Roth accounts.

ıxes During Retirement—Including Taxes on Social Security Benefits

lDs, or mandated distributions that must be taken from traditional, non-Roth retirement accounts ıy cause you to pay more income taxes than anticipated during retirement. And be aware that **even ur Social Security benefits may be taxed**. In fact, since 1984, your Social Security benefits may be ‹ed up to 85% based on your annual “combined income” calculation. (Annual “combined income” uals your adjusted gross income, plus any nontaxable interest you earned, certain other income, and lf of your Social Security income.)

your combined income exceeds $32,000 per year filing ntly, you will owe taxes—in fact, Social Security estimates ıt 56% of families will owe federal income tax on their nefits through 2050. Joint filers with a combined income tween $32,000 and $44,000 will pay taxes on up to 50% their Social Security benefit, while those with combined ome of more than $44,000 will pay up to 85%.

Taxes Owed by Beneficiaries and Heirs

The potentially biggest tax bomb, which may not be fully understood by the public yet, is the tax burden that may be left for non-spousal heirs who inherit traditional retirement accounts from their parents or grandparents. Due to the passage of the SECURE Act, most non-spouses who inherit a taxable retirement account like a 401(k) or IRA (with some exceptions) must:

1) **Take annual RMDs and pay income taxes on amounts withdrawn based on the original owner's timetable and,**
2) **Completely liquidate their inherited account in 10 years and pay taxes on the entire remaining balance.**

This typically forces heirs into higher tax brackets—possibly even be the highest federal bracket. And if you include state taxes, your heirs may pay over 40% of what you left them in taxes! Furthermore, if the estate is large enough, IRAs may become an even bigger tax bomb as heirs run the risk of double taxation if not properly planned for.

OPTIONS FOR DEFUSING THE TAX BOMB

Roth Conversions

Conducting a series of Roth conversions and paying taxes on the conversions before retirement—or at the beginning of retirement—is one option to defusing the tax bombs before they have the chance to go off. Roth conversions allow you to convert taxable retirement money into after tax Roth accounts, paying taxes on converted amounts in the years the conversions are done. (These must be done carefully, as they cannot be undone! Be sure to work with your tax professional.)

As long as the Roth account has been in place for five years or longer and you are at least age 59.5, withdrawals and gains are tax-free, and RMDs are not required.

For your beneficiaries, the same rules apply. If the account has been in existence 5+ years, inherited Roth accounts are tax-free with no RMDs required. However, non-spousal heirs of Roth IRA accounts must drain and close them within 10 years of inheritance.

But there is another option: Life Insurance

For those age 59.5 and older in relatively good health, consider taking distributions and leveraging your money with tax-advantaged life insurance rather than leaving assets in traditional 401(k)s and IRAs until the RMD annual due dates.

Not only can this strategy provide a leveraged, tax-free benefit for your beneficiaries, but it may also provide for tax-free withdrawals (retirement income in the forms of loans from the life insurance policy) in the future for you if you need them.

In other words, you may be able to leave more to your heirs and have additional features available for yourself.

Life Insurance Case Study: Mr. & Mrs. Jones

- Mr. and Mrs. Jones are aged 60 and 57 respectively
- They have two adult children and several grandchildren
- They have $1,000,000 in a traditional IRA (Mr. Jones)
- They have $5,000,000 in non-qualified assets
- The Jones do not need income from his traditional IRA and were advised by their advisor to push distributions to RMD age.
- They would like additional tax-free income available at age 75 and have considered Roth conversions.

NOTE: The following IUL case study numbers are based on actual information as of March 2025, but each individual case is completely unique. Work with your financial, legal and tax advisors to analyze and examine your own personal situation.

Proposed Solution for The Jones: IUL (Indexed Universal Life) Policy

Mr. Jones can begin taking distributions from his IRA today, at age 60, and potentially leverage those withdrawals for a tax-free death benefit and tax-free income in the future if needed by purchasing an IUL policy.

Assuming Mr. Jones withdraws $50,000 per year for 12 years from his IRA and uses the money to fund an indexed universal life (IUL) policy with an A-rated carrier, the Jones will have:

A $1,061,849 Immediate Death Benefit

If Mr. Jones was to unfortunately pass away right after his IUL policy went into effect, his beneficiaries would receive the death benefit of $1,061,849 plus his traditional IRA amount of $1,000,000 minus the first $50,000 premium. That is a lot of leverage.

While the insurance death benefit in most cases is tax-free, Mr. Jones' heirs would still have to take RMDs, pay taxes, and empty the remaining $950,000 in the traditional IRA within 10 years of inheritance.

Potential $2,478,735 Death Benefit at Age 90

At age 90, while the death benefit is not guaranteed, based on historic S&P 500 and Nasdaq 100 average returns and performance, the potential death benefit could be nearly $2.5 million if no loans or cash are taken out and the policy remains in force, while the amount paid for premiums is estimated to be $600,000 ($50,000 per year for 12 years).

Potential $875,845 Cash Value at Age 75

While this cash value amount in the IUL policy is not guaranteed, based on historic S&P 500 and Nasdaq 100 average returns and performance, when Mr. Jones is age 75, the amount available to borrow tax-free—for any purpose, including retirement income—could be $875,845, while what was paid for premiums would still be estimated at $600,000 ($50,000 per year for 12 years).

Keep in mind that there could still be plus or minus $400,000 remaining in Mr. Jones' traditional IRA, depending on stock market returns and investment performance. Heirs would have annual RMDs on that IRA remainder and would have to close the account in 10 years and pay income taxes on the balance.

Additional Benefits Available as Part of the IUL Policy

For this case study, the Jones' IUL policy also provided up to $500,000 in an accelerated death benefit amount available in the case of the development of terminal or chronic illness.

Optional Funding Strategy: Using an FIA to pay for IUL

Because an IUL (indexed universal life) policy will have multiple years of premium payments, a popular funding vehicle inside a client's traditional IRA is the utilization of a fixed indexed annuity (FIA), which can provide the money to pay the IUL premiums.

- FIAs are a contract between an insured and an insurance company. Not actually invested in the market, instead, FIAs are benchmarked to an index like the S&P 500, and earnings or policy credits are based on the index's performance. When the index rises, the FIA is credited based on contract terms. If the index falls, the principal is protected based on insurance company strength.

  This is important because the FIA owner will know exactly how much they have to cover the IUL annual premiums and do not have to worry about a market correction or bear market affecting their ability to fund their IUL policy.

- Some FIAs have a free partial withdraw feature that is utilized to fund the IUL.
- Many FIAs also offer immediate cash bonuses, increasing their value.

NOTE: The following FIA funding case study numbers are based on actual information as of March 2025, but each individual case is completely unique. Work with your financial, legal and tax advisors to analyze and examine your own personal situation.

Funding Vehicle for Mr. & Mrs. Jones' IUL Policy: FIA

If the Jones decide that they want more certainty in paying for their IUL policy, they may choose to purchase an FIA policy, using the FIA's regular annuity payment to pay the IUL premium.

For this example, Mr. Jones would take a direct rollover of $500,000 inside his traditional IRA to fund an FIA policy with a 20% cash bonus with a high liquidity provision beginning Year 1.

Mr. Jones' FIA Rollover Features:

- **20% Cash Bonus**

  This would allow Mr. Jones an effective 20% gain on half of his traditional IRA assets without worrying about a future market correction.

- **Principal Protection**

  Unlike some annuities, such as VAs (variable annuities) and RILAs (registered indexed-linked annuities), FIAs are not actually invested in the stock market, they are insurance contracts. Fixed indexed annuity policies guarantee* a certain payment for a certain period, with the possibility of growth benchmarked to a stock market index, while the policy's principal remains protected from market losses. (*Guarantees are provided by the strength of the insurance company providing the FIA.)

- **Many Benchmarked Index Choices**

  Mr. Jones' FIA offers multiple index choices, like the S&P 500, Nasdaq 100, Russell 2000.

- **10% Free Partial Withdrawal (FPW) / 30% Cumulative FPW**

  Mr. Jones can withdraw part of his original premium on Day 1, and use cumulative free partial withdrawal amounts in future.

Mr. Jones' FIA Funding Overview:

- $500,000 rollover fixed indexed annuity one-time premium cost
- $600,000 immediate value (due to the 20% cash bonus)
- $50,000 annual withdrawal for 12 years to fund the IUL
- Potential $96,679 - $404,199 non-guaranteed cash value after 12 years

Mr. Jones' Remaining IRA after FIA Rollover:

- $500,000 still in the traditional IRA
- Potentially worth $1,000,000 in 12 years using 6% annual return and rule of 72 – less RMDs annually beginning at age 73.

The Jones' Case Study Conclusion: Mitigating Tax Bombs

Instead of waiting to take traditional IRA distributions until the RMD days beginning at age 73—and paying the heavy tax burden—the Jones' can take earlier withdrawals while they are still healthy, leveraging life insurance and using a fixed indexed annuity as the funding vehicle for the guarantees. This can potentially improve their financial situation in case of an unexpected tragedy, and also potentially leave a larger legacy for beneficiaries, in most cases tax-free.

Sources:

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