When Your IRA Becomes a Tax Time-Bomb

Individual Retirement Accounts have for years been the most popular retirement savings alternative for people who want high interest and tax shelter for their retirement savings. In the last 20 years, billions of dollars have been invested in these accounts by individuals seeking safety and predictability, competitive rates of return and favorable tax treatment. If you currently own an IRA, there is something you should know that is seldom mentioned by the company or the agent who presents it.

One of the most important features of an IRA is that it allows you to take an income-tax deduction on the money you contribute to the plan and compound yearly earnings free of current tax. By eliminating the current tax cost on the deposits and on the accumulation, you can build a much larger account value than with a typical interest bearing account such as a bank CD. When you combine these features with a slightly higher interest rate than is typically found in bank savings, it is easy to see why IRAs are so popular.

IRA's are great for accumulating money to be used at some future date to enhance income; as long as it is understood that when you begin to withdraw money from the plan you must then pay taxes on all that you withdraw. Many people find that, in retirement, their needs for income are less than expected and they are able to get along just fine on the income from other sources without taking money from their IRA. As long as the money remains in the plan, it will be sheltered from taxes. But IRS regulations require that, regardless of your need (or lack there of) for additional retirement income, you <u>must</u> begin taking distributions from the plan at age 70 ½. You are given a choice of formulas to determine the amount of income you must take, and most people choose the one which will allow the most money to remain tax-sheltered in the plan.

The Unknown Tax Trap

It is at the time of the total withdrawal of funds, which most often occurs upon the death of the owner, that the surprise occurs.

An IRA does not get a "step-up in basis" at the time of your death. It is quite common today to see real estate and stocks that have been owned for years and that have appreciated ten fold to a hundred fold be passed on to heirs upon the death of the owner with no income tax whatsoever. But an IRA does not enjoy this tax feature. Specifically excluded from the step-up in basis rule, all of the money in the plan, including all of the deposits and all of the gain is subject to income tax when received by the beneficiary.

Since a vast majority of the $Billions now residing in IRAs is destined to be passed on to the children of the owners, the tax bills will come as a tremendous shock to all concerned. In fact, it is not uncommon to see proceeds from an IRA that has been accumulated and tax sheltered in a relatively low tax bracket, incur taxes of 33% or more when added to the existing income of the beneficiary. This clearly was not the intent of the IRA owner. But it occurred because of the failure to recognize that there is now a *new* purpose for the money on deposit in the IRA and to choose a new, more appropriate strategy.

The Better Strategy

There is an alternative to the IRA that will satisfy the *new* objectives of saving money for an emergency and passing any unused balances to our heirs. It provides tax deferral, safety and immediate liquidity, but when it passes to a beneficiary upon the death of the owner, there is a major difference. The entire tax-sheltered accumulation passes <u>income tax-free</u> to the named beneficiary.

The product is a special life insurance policy designed for acceptable cash value growth and a very high estate benefit to the heirs. People who are planning on passing their IRA's on to their children at death will find that the after tax benefits will be substantially higher if the money is accumulated in a life insurance policy rather than an IRA when they die. Not only does it include the money which accumulated in the cash value account, but an additional amount of life insurance benefit that is paid to the beneficiary. This combination, paid income tax free, is the most desirable way to pass IRA's to children or other named beneficiaries.

Getting From an IRA To Life Insurance

Once most people realize the benefit of using life insurance, they seek the most efficient way to transfer the money from the IRA. Unfortunately, there is no way to make a tax-free transfer of the balance from an IRA to a life insurance policy. In other words, the tax must always be paid. But the sooner you recognize the income, the less sheltered tax you will be accumulating.

If the life insurance approach matches your desire to transfer your money to your loved ones, move the money as soon as possible. The sooner this transaction occurs, the less taxes will be paid. It's really OK to pay these taxes now because they will ultimately be *recovered* by the life insurance element that will be paid to the beneficiary in addition to the cash value.

Assume a lady (Sally) who is 70 years old who owns an IRA which is now worth $70,000. If it continues to accumulate until she is 78 years old when she dies, it will have a value of approximately $111,569. But when her beneficiary receives it, income taxes will be due on the entire $111,569. At 33% the taxes would be $36,818 leaving a final balance of $74,751 for the heirs.

TYPICAL EXAMPLE - IRA VS LIFE INSURANCE

Sally Saver - Female, Age 70

RETAIN THE IRA		LIQUIDATE IRA OVER 7 YEARS AND PURCHASE LIFE INSURANCE POLICY	
Current Balance	$ 70,000	Annual Proceeds	$ 10,755
Accumulated @ 6%		Tax @ 20%	$ 2,151 per year
Value @ Age 78	$111,569	Annual IRA Proceeds:	
Death Benefit	$111,569	$10,755-$2,151=	$ 8,604
Tax @ 33%	$ 33,818	Premium Deposit	$ 8,604 per year
		Initial Death Benefit	$123,000
Proceeds to Heirs:		Proceeds to Heirs:	
$111,569-$36,818=	**$ 74,751**	$123,000-$0=	**$123,000**
		(Increase to Heirs	$ 48,249)
Total Paid in Taxes	*$ 36,818*	*Total Paid in Taxes*	*$ 15,057*

If instead she were to begin liquidating her IRA over 7 years, her taxes would be approximately $2,151 per year, leaving $8,604 per year for seven years to deposit into a life insurance policy.

This would purchase a contract with a death benefit of approximately $123,000*. Now if she died at age 78, her children would receive $123,000 instead of $74,751.

As you can see, the added benefit available from the life insurance policy more than compensates for the current taxes Sally must pay now to cancel her IRA and move the money. The money in the cash value of the insurance policy continues to grow tax sheltered (like the IRA) and is available should it be needed for an emergency.

Of course, there are several ways to address this situation and depending on your individual needs, current health, and other personal factors the benefits could be greater or less than this example. There are special versions of these policies that can also provide benefits to cover nursing home and convalescent care by making the larger death benefit available to the insured (prior to death) to help pay for these costs.

It is best to consult with a qualified advisor to evaluate your personal options to determine if this is a better option for you than the IRA. Further exploration of the life insurance alternative could be a very valuable step for you as well as your loved ones.