

**When is the best  
time to pay income  
taxes on an IRA?**



## **The Dilemma**

Many people who have been successful in saving for retirement have established a large enough nest-egg to be able to create a legacy for their children, grandchildren and favorite charities, leaving them to wonder how to best leverage their qualified or tax advantaged retirement plans.

A common question is whether IRA owners should take larger withdrawals and pay income taxes now, or whether they should take out as little as possible during their lifetime, leaving a likely income tax burden for their heirs and beneficiaries.



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# Tax Saving Alternatives for IRAs

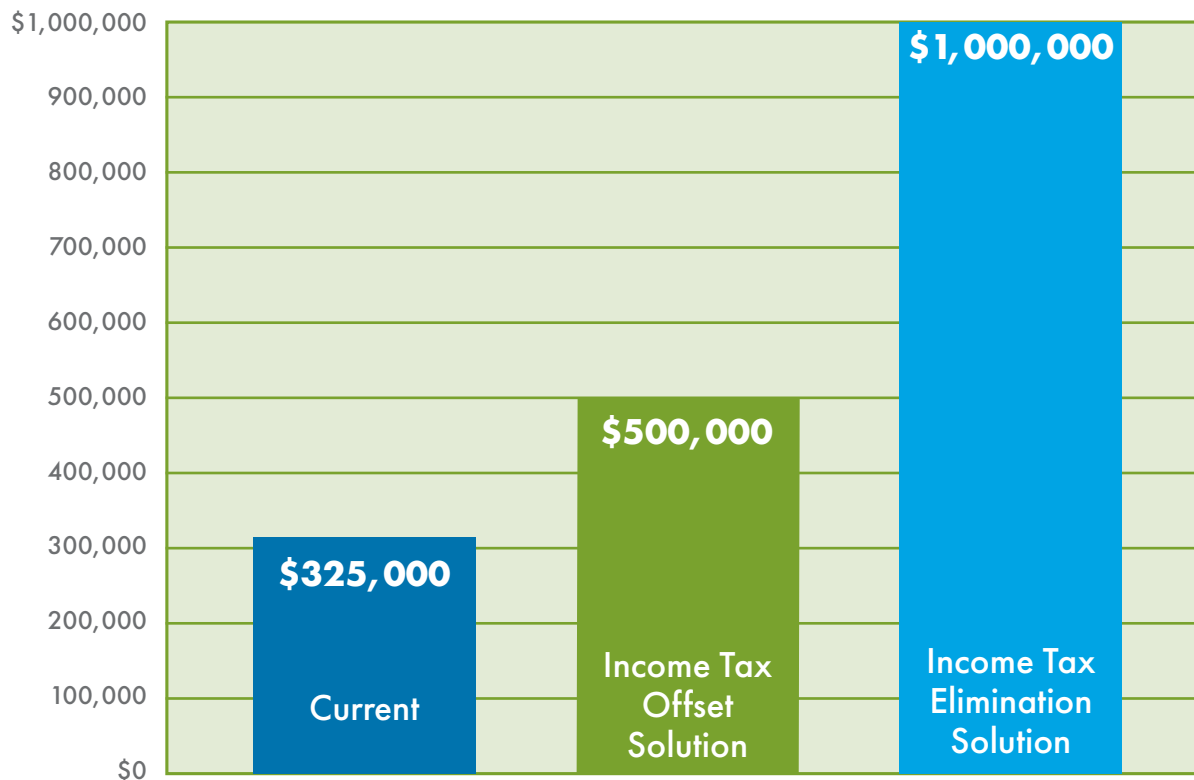
If an IRA owner is looking to protect loved ones and to maximize wealth transfer, he/she can utilize life insurance to minimize the tax burden that inheriting an IRA may impose on a beneficiary. With two different strategies identified in this brochure, investors can **maximize the after-tax** value of their IRA or even **eliminate taxes paid** on the IRA inheritance.<sup>2</sup>

The chart below provides a comparison of what IRA distributions look like on the same IRA account before (“Current” bar) and after (“Tax Offset” and “Tax Elimination” bars) the two solutions where used. These powerful strategies can provide significant tax savings, maximize the amount of money beneficiaries receive from IRAs and provide greater flexibility in how the assets are ultimately put to use.

**43% of respondents to a recent study said their ideal retirement investments enable them to leave money to their family, community or charities.<sup>3</sup>**

## IRA Distribution Amounts

Comparison of IRA Wealth Transfer Solutions



Fees and charges, if applicable, are not reflected in this example and would reduce the amount shown. Income taxes on tax-deferred accounts are payable upon withdrawal. Federal restrictions and a 10% federal early withdrawal penalty may apply to withdrawals prior to age 59½. This information is hypothetical and only an example. It does not reflect the return of any investment and is not a guarantee of future income.

# IRA Required Minimum Distributions

Proper consideration should be given to IRA distributions and the resulting tax implications as these can affect the amount a beneficiary may inherit upon IRA owner's death.

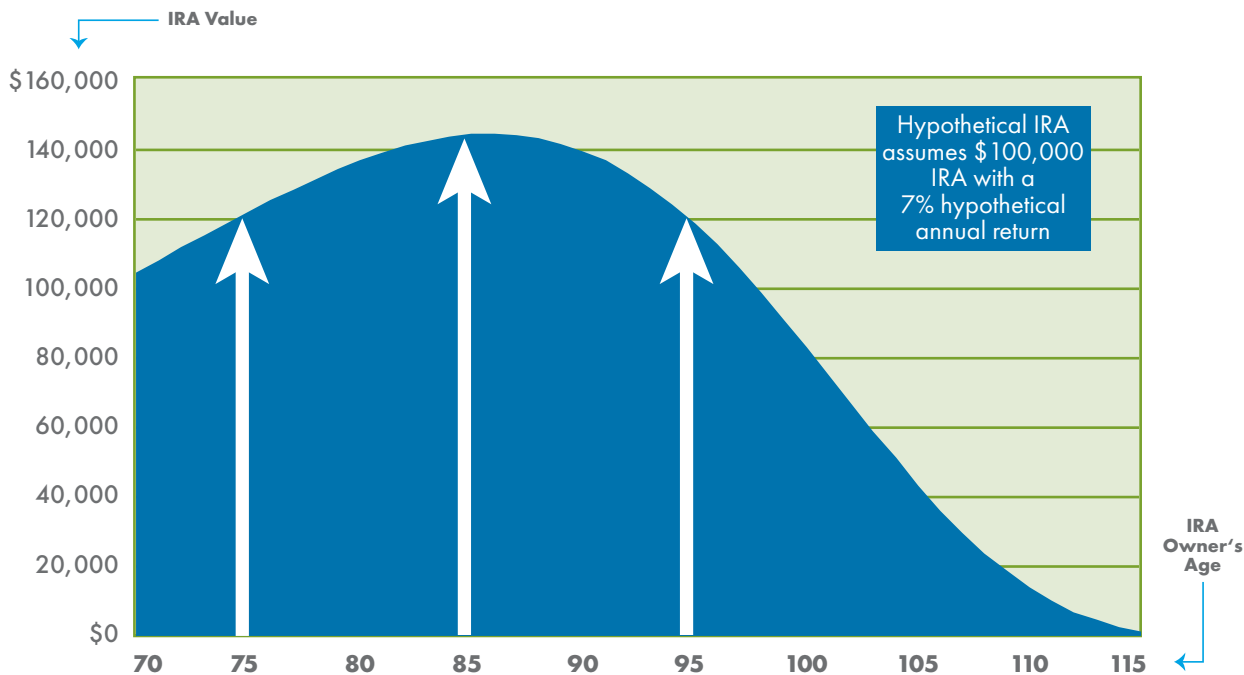
- Beginning at age 70½, the IRA owner is required to withdraw an increasing percentage of an IRA's account value each year until the IRA is exhausted – "Required Minimum Distribution (RMD)".
- Eventually RMDs will be larger than the expected annual interest growth. When that happens, the IRA may well be at its peak value, typically between ages 85 and 90, as depicted in the chart below.<sup>1</sup>

- When an IRA owner dies, the beneficiary must include taxable amounts received in his or her gross income.
- Because IRAs are frequently transferred at or near their peak value, IRA inheritances are often taxed at higher income tax rates.

It is not uncommon for retirees to die sometime between their 75th and 95th birthday. As the graph below depicts, when that happens IRAs are often passed to the next generation at-or-near peak values. Because these IRA inheritances are fully taxable to the beneficiaries as ordinary income, they are often taxed at very high rates.

## Hypothetical IRA Peak Value Estimation

Due to Required Minimum Distributions



The chart assumes an 7% annual rate of return. Fees and charges, if applicable, are not reflected in this example and would reduce the amount shown. Income taxes on tax-deferred accounts are payable upon withdrawal. Federal restrictions and a 10% federal early withdrawal penalty may apply to withdrawals prior to age 59½. This information is hypothetical and only an example. It does not reflect the return of any investment and is not a guarantee of future income.

# Innovative Solutions for IRA Wealth Transfer

The two solutions described here help reduce or eliminate the taxes imposed on an IRA beneficiary, thus maximizing the value of the inheritance.

**“Current” Scenario** It is not uncommon for an IRA owner to reinvest his/her mandated IRA RMDs while using other portfolio assets for retirement and living expenses. This leaves the majority of the IRA balance intact and transferred, along with the tax liability, to the beneficiary at the owner’s death<sup>4</sup>.

- At IRA owner’s death, bulk of IRA is intact and paid to beneficiary
- Income taxes are due on the IRA amounts received by the beneficiary<sup>5</sup>
- If a beneficiary is in his/her 50’s and 60’s (often the case) at IRA owner’s death, earning his/her highest career income, he/she will pay taxes in a high income tax rate.
- The addition of IRA inheritance to beneficiary’s existing taxable income could push the recipient into a higher tax bracket.
- This can result in excessive income taxes to the beneficiary, reducing the net value of his or her inheritance — see diagram below for an example.
- The constraints of maintaining the asset’s tax deferred status may not meet the beneficiary’s existing financial and retirement planning needs.

**Estimating Tax Impact of IRA Inheritance**

Determine hypothetical value of IRA when it would be transferred to beneficiary

Estimate income tax beneficiary would owe if inherited as a lump sum when IRA owner dies at 80

Estimated value at age 80 .....	x Estimated income tax rate.....	= Taxes owed by beneficiary
\$500,000 .....	x 35% .....	= \$175,000 reduction in IRA value

## SOLUTION 1: Offset IRA Beneficiary Income Taxes

Use IRA RMDs to help pay for a life insurance policy equal to income tax due from beneficiary at time of inheritance. Life insurance benefit pays income tax due, full value of the IRA is maintained.

**IRA Income Tax Offset Solution**

Determine hypothetical value of IRA value when it would be transferred to beneficiary

Estimate income tax beneficiary would owe if inherited as a lump sum when IRA owner dies at 80

Use portion of RMD to purchase life insurance equal to beneficiary’s estimated taxes at time of inheritance

Estimated value at age 80 .....	x Estimated income tax rate.....	= Taxes owed; purchase life insurance for this amount
\$500,000.....	x 35%.....	= Beneficiary receives life insurance benefits of \$175k to pay taxes thus retaining full peak IRA value of \$500k

## Results

Beneficiary receives life insurance death benefits **income tax-free** and can use those funds to pay the taxes due on IRA inheritance.<sup>6</sup>

- Now, beneficiary owns the IRA funds and all of the income taxes have been paid. Beneficiary has discretion to invest/use full amount of IRA funds without penalty taxes or required distributions.

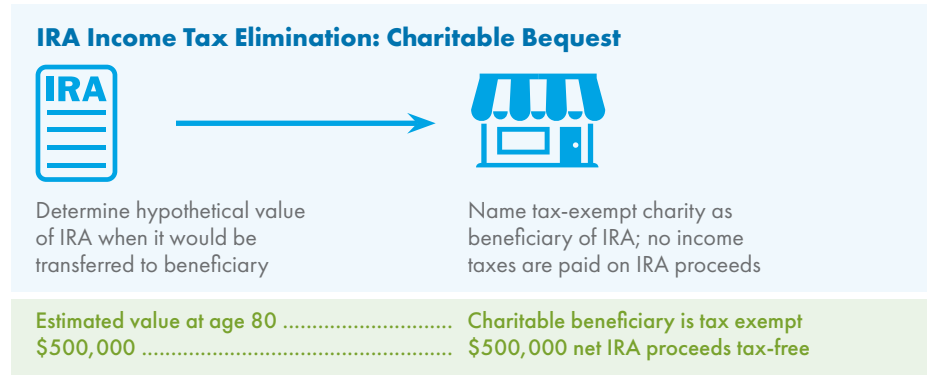
## SOLUTION 2: Eliminate IRA Beneficiary Income Taxes

By creatively incorporating a charity and the IRA's RMDs to fund a life insurance policy for beneficiaries in a similar but slightly different manner as Solution #1, the federal taxes on the distribution of an IRA can be completely eliminated.

### Part 1

Name a tax-exempt charity as the IRA beneficiary. With the charity's tax exempt status, no taxes will be due on the inherited IRA funds.

*See example at right:*

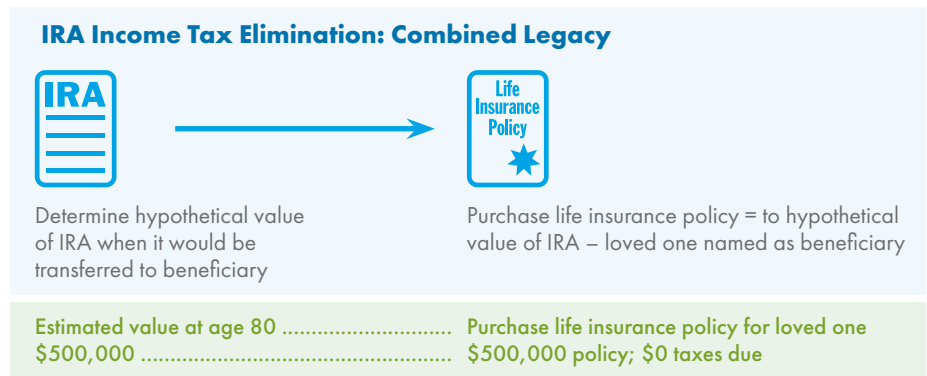


### Part 2

This solution can be taken a step further to incorporate a loved one as a beneficiary.

Use IRA RMDs to help pay for a life insurance policy equal to the estimated peak value of the IRA. Loved ones can be named as beneficiary of the life insurance policy and would receive the life insurance death benefits income tax-free under the current tax law <sup>6</sup>.

*See example at right:*



## Results

Total wealth transferred (\$1,000,000) is more than three times the amount of net after-tax IRA inheritance in original scenario on page 2 (\$325,000), and the income taxes have been eliminated.

- Beneficiary of life insurance policy receives full death benefit (equal to estimated IRA value) income tax-free<sup>6</sup>.
- Charitable IRA beneficiary receives full value of IRA income tax-free (at IRA owner's death)
- Zero taxes are paid on either the IRA or the life insurance policy

## Find out more

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or visit [RetireStronger.com](http://RetireStronger.com).

- <sup>1</sup> Depends on life expectancy factors, the assumed annual rate of return and additional deposits or withdrawals made.
- <sup>2</sup> American General Life Insurance Company and their distributors and representatives may not give tax, accounting or legal advice. Any tax statements in this material are not intended to suggest the avoidance of U.S. federal, state or local tax penalties. Such discussions generally are based upon the company's understanding of current tax rules and interpretations. Tax laws are subject to legislative modification, and while many such modifications will have only a prospective application, it is important to recognize that a change could have retroactive effect as well. Individuals should seek the advice of an independent tax advisor or attorney for more complete information concerning their particular circumstances and any tax statements made in this material.
- <sup>3</sup> The AIG Retirement Re-Set<sup>SM</sup> Study is a public opinion poll conducted in the United States by Harris Interactive with telephone interviews among 3,426 respondents aged 55 or older.
- <sup>4</sup> Additional deferral may be extended based upon titling and certain beneficiary elections; however income tax liability will vest upon ultimate distribution as ordinary income.
- <sup>5</sup> Under current law, beneficiary may defer immediate taxation by electing to take required annual distributions from an inherited IRA over his/her life expectancy. Additionally, a surviving spouse beneficiary may transfer the IRA into his/her own name and delay distribution until age 70 1/2. However the taxation portion of the IRA at date of death will ultimately be subject to federal income tax.
- <sup>6</sup> Life Insurance death benefits are generally tax-free for beneficiaries under IRC 101(a), but may be taxable in part or whole under certain situations.



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