Using life insurance as part of your IRA legacy plan

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How much of your IRA will beneficiaries actually keep after taxes? Using IRA distributions to fund life insurance may help convert a portion of that wealth into a more tax-efficient legacy asset.

Key points

- Inherited IRA assets may be less tax-efficient than expected, as required withdrawals and ordinary income taxation can reduce the amount ultimately received by beneficiaries.
- Using IRA distributions to fund life insurance may help convert a portion of taxable retirement assets into income tax-free proceeds, changing the composition and predictability of what beneficiaries receive.
- The most effective approach depends on individual preferences and circumstances, and many families may consider a combination of strategies over time.

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When Traditional IRA or 401(k) assets are passed to beneficiaries, they are generally taxed as ordinary income and often must be withdrawn within 10 years, meaning a significant portion may ultimately go toward taxes rather than family.

This dynamic can be particularly impactful when retirement assets may not be needed to support retirement spending. In those cases, an important planning question often comes to mind: *If these assets won't be needed for spending, how can more of their value go to family instead of taxes?*

With strategic planning, there may be opportunities to improve the after-tax value ultimately received by beneficiaries. One potential approach involves using retirement distributions to fund life insurance, which may help convert a portion of taxable retirement assets into income tax-free death benefits for the next generation.

Why this matters for investors with substantial IRA assets
For some families, particularly those with significant IRA balances or lower spending needs, a portion of these assets may not be needed for lifetime spending. In those cases, the role of the IRA can shift from funding retirement to serving as a legacy asset, creating a different set of planning considerations.

Several strategies may be considered in these situations. This article focuses on one approach that may be particularly relevant when the objective is to improve the amount beneficiaries may ultimately receive after taxes.

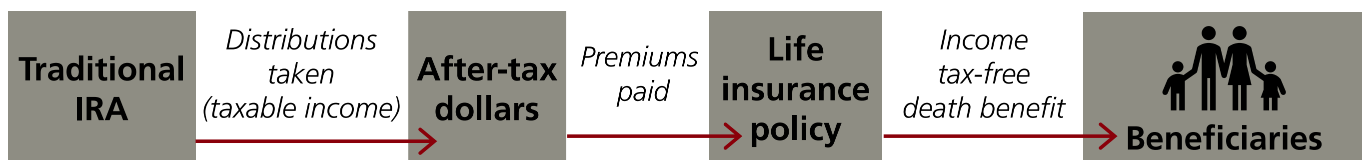
One potential approach: using IRA distributions to fund life insurance
One strategy involves using retirement distributions in a different way. Instead of simply reinvesting required minimum distributions (RMDs), or taking withdrawals without a broader legacy plan, a portion of those distributions may be used to fund a life insurance policy.

When structured appropriately, life insurance proceeds are generally received income tax-free by beneficiaries.

This does not mean life insurance will always produce a better outcome than other planning approaches. Rather, it may be worth evaluating when the goal is to create a more predictable, more tax-efficient legacy.

How the strategy works
This strategy may be relevant for individuals who have significant Traditional IRA or 401(k) assets, do not expect to rely on all of those assets for spending, intend to leave assets to family members or other non-charitable beneficiaries, are concerned about the tax impact of inherited retirement accounts, and who may qualify for life insurance at an affordable cost.

Over time, distributions are taken from the IRA. After taxes are paid on those withdrawals, a portion of the remaining funds may be used to pay premiums on a life insurance policy.



As this process continues, three sources of wealth may be created:

- Remaining IRA assets, which may still be passed on to beneficiaries but are generally taxable when withdrawn
- Life insurance proceeds, which are generally received income tax-free by beneficiaries when structured appropriately
- Taxable assets, which generally receive a step-up in cost basis when transferred at death

It's important to note that this type of planning does not need to begin only at RMD age. In some cases, it may be considered earlier depending on cash flow, tax planning considerations, health, insurability, and legacy objectives.

How might this impact outcomes

The example below uses a simplified set of assumptions (see "Assumptions and methodology" section at the end) to show how outcomes may differ depending on how IRA assets are used over time. The goal is to illustrate what beneficiaries might ultimately receive (net of income taxes) if assets are left as is versus if a portion is used to fund a life insurance strategy. Actual results will vary based on factors such as investment returns, tax rates, health, and insurance structure, but this example helps illustrate the potential impact on the outcome that may matter most: the amount passed on to family.

Without planning (i.e., the "do nothing" approach), most or all of the inheritance may come from taxable IRA distributions. These withdrawals are generally subject to ordinary income taxes and timing constraints, including the 10-year withdrawal rule that applies to many beneficiaries.

With a life insurance strategy, part of the legacy may instead come from life insurance proceeds, which are generally not subject to income tax.

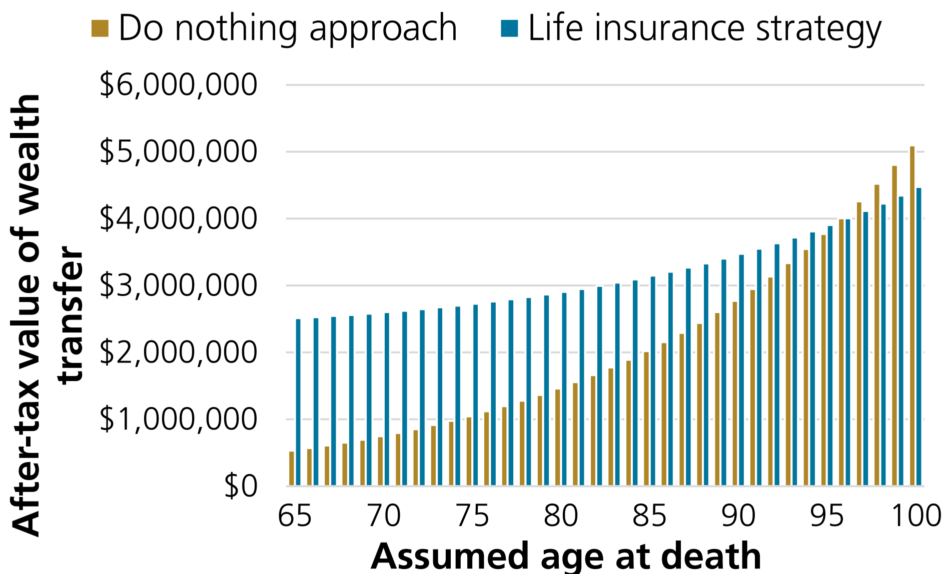
This may change the overall result in several ways, including reducing exposure to future income taxes and limiting the impact of timing rules such as the 10-year withdrawal rule for Inherited IRAs. Additionally, this strategy may create a larger guaranteed or projected amount for beneficiaries sooner than investing alone would provide, depending on policy design, costs, health, time horizon, and portfolio returns.

That last point is important – life insurance does not necessarily grow more than an investment account. In fact, investment-based strategies may provide more upside over longer time horizons, while life insurance gives a higher return on investment for those with a shorter time horizon (which is why life insurance usually requires you to be healthy).

In this context, adding life insurance to the portfolio helps to provide greater certainty—a higher "floor" on outcomes through the contractual death benefit—which may be especially valuable when the planning goal is legacy rather than future income.

Figure 1 - What beneficiaries may receive after taxes

Illustrative comparison of after-tax values transferred to beneficiaries at different assumed ages at death under the "do nothing" approach and a life insurance strategy



Source: UBS. For illustration purposes only.

Note: Analysis assuming a $1,000,000 IRA is partially distributed over time to fund a life insurance policy with a $2,000,000 death benefit. Net benefit reflects combined value of the remaining IRA (after taxes), any accumulated taxable assets, and life insurance proceeds.

Put simply, the trade-off is often: investment-based strategies rely on growth over time, whereas life insurance may create a more predictable benefit sooner. The right balance of these options will depend on the family's goals, time horizon, tax situation, health, and the need for flexibility.

Sizing considerations

Deciding how much life insurance may be appropriate isn't always straightforward. It often depends on factors like the size of the IRA, expected withdrawals, tax considerations, underwriting considerations, and overall legacy goals. Because

these inputs can vary significantly from one family to the next, this is typically an area where it can be particularly helpful to work through the trade-offs with a financial advisor.

For those interested in exploring this further, a more detailed framework is available in the CIO Research report, How to leave more of your IRA assets to your family (published 8 July 2024).

What other approaches are there?
When IRA assets may not be needed for spending, the question becomes how those assets will ultimately be transferred. Several approaches may be considered, each with a different impact on what beneficiaries receive. When beneficiaries inherit pre-tax dollars, they must take required minimum distributions (RMDs) from the inherited IRA subject to the "10 year rule," which may lead to logistical headaches and a potentially significant tax burden.

	What happens during lifetime	What beneficiaries receive
Do nothing	The IRA remains invested. RMDs are taken over time and after-tax amounts not needed for spending may be reinvested in a taxable account.	Remaining IRA assets, generally taxable upon withdrawal, plus any taxable assets built from reinvested distributions.
Life insurance strategy	IRA distributions are used to fund life insurance premiums. Any after-tax distributions not used for premiums may be reinvested in a taxable account.	Remaining IRA assets, taxable assets from reinvested distributions, and generally income tax-free life insurance proceeds.
Roth conversions	IRA assets are converted to a Roth IRA, with taxes paid during lifetime.	Roth assets that may generally be withdrawn income tax-free, subject to applicable rules.

In practice, many families don't rely on just one strategy. It's often a combination where different parts of an IRA are used in different ways over time. For example, some assets may remain invested, while others may be used to fund life insurance or converted to a Roth IRA, depending on what the family is trying to accomplish.

The optimal approach really comes down to personal preferences as it relates to income needs, time horizon, tax considerations, and how much certainty or flexibility someone wants in their plan. This is why it can be helpful to step back and evaluate these choices in the context of a broader financial plan.

Additional considerations: estate planning and ILITs
For individuals who expect to have a taxable estate, there may be an additional step worth considering: holding life insurance within an Irrevocable Life Insurance Trust (ILIT). Because the trust is generally outside of the taxable estate, the policy's death benefit may not be subject to estate taxes. Trust structures may also provide additional control over how and when proceeds are distributed to beneficiaries.

As with other aspects of this strategy, these decisions are highly dependent on individual circumstances. Many individuals may find it helpful to evaluate these considerations in coordination with a financial advisor, estate planning attorney, and life insurance specialist. For a more detailed discussion, see the UBS Advanced Planning Group report, Life insurance.

Conclusions and next steps
Incorporating life insurance into a portfolio may help to increase the after-tax wealth that can be passed to the next generation.

By working with a financial advisor, families may be able to earmark a portion of their IRA to help fund life insurance using funds they won't need for their lifetime spending—in essence shifting a portion of that wealth into income tax-free proceeds.

This strategy can be combined with other approaches, such as Roth conversions, to help find a combination that strikes the right balance of flexibility, tax efficiency, and certainty.

Assumptions and methodology
In each scenario, the individual is assumed to be 65 years old with a $1 million Traditional IRA. The IRA is assumed to grow at a consistent annual rate of 7%, while any taxable investments are assumed to earn a 6% after-tax return.

The analysis assumes the individual lives to age 100. In the life insurance scenario, annual distributions from the IRA are used to pay associated income taxes and fund life insurance premiums. The cost of life insurance is estimated at approximately $10,000 per $1 million of death benefit, which may vary based on health, age, and product design.

Both the IRA owner and their beneficiaries are assumed to be subject to a combined income tax rate of 50.3% (37% federal and 13.3% state). All life insurance death benefits are assumed to be received income tax-free by beneficiaries.

This analysis is intended to provide a simplified comparison and does not reflect all variables that must be considered in practice. It does not account for potential changes in tax law, investment performance, or differences in life insurance policy structures. Federal and state estate taxes are not considered.

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