2 good reasons to move IRA funds to permanent life insurance

Clients want guarantees, growth, control, safety, protection, access, liquidity and low taxes. Here's how to do all of that.

Oct 17, 2016 | By Ed Slott

(Photo: Thinkstock)

A large IRA sounds good, but it may be too much of a good thing. The larger an IRA balance grows, the greater the retirement debt that will be owed in taxes.

The IRA problem

If at all possible, debt should be eliminated before retirement. The retirees who are debt-free are proud of that fact. To most people, being debt free means having no more home mortgage, having no credit card debt and not owing any money to anyone.

But if they have a large IRA or other tax-deferred retirement account, they actually have a looming debt to the IRS. As that IRA grows so does that debt, just like an unpaid credit card, compounding as the account value increases.

While the tax debt is deferred, the deferral is limited due to required minimum distributions (RMDs) that force the taxes out with withdrawals beginning after age 70 ½. The problem with this retirement debt: Unlike the interest rate on a home mortgage, the tax rate on future IRA withdrawals is unknown.

That creates uncertainty, especially when it is likely that tax rates will increase. And they will be based on a larger balance the longer the IRA is left to grow tax-deferred.

Unlike other non-IRA type investments, funds in IRAs and 401(k)s at death remain taxable. There is no step-up in basis, as there would be for a highly appreciated stock held outside of an IRA, eliminating the income tax at death. IRA and 401(k) beneficiaries are subject to tax on post-death RMDs.

In addition, if the estate including the IRA is large enough, the IRA can be subject to estate taxes as well. In that case, there is a corresponding tax deduction (the deduction for income in respect of a decedent), but only for federal estate taxes, not state estate taxes.

IRA funds are often invested in the stock market, so they are also subject to that market risk. Traditionally, the stock market increases over time, but if the market declines when retirement funds are needed, less of the remaining funds are available for future growth. This is the classis sequence of returns risk that depletes needed retirement funds.

On the contribution side, annual IRA contributions are limited to small amounts ($5,500 per year or $6,500 for those ages 50 and over). Plus contributions for traditional IRAs are no longer permitted once the client reaches age 70 ½.

For all of these issues, large IRAs are in fact a poor retirement vehicle. There are too many risks and uncertainties. That is not a good foundation for a long-term retirement plan.

When asked, most clients approaching or in retirement want more certainty. They also want guarantees, growth, control, safety, protection, access, liquidity and low or no taxes. But most of all, they want to sleep at night.

They want peace of mind. Large IRAs will not provide that, but these IRA funds can be leveraged to gain *all* of that by transitioning those funds to a permanent life insurance policy. When IRAs grow too much, they need to be trimmed. Yes, that means paying taxes upfront, but there are two benefits to this.

1. **Take advantage of low tax rates.** One is that tax rates right now are as low as they may ever be, but you would of course check this with each case. In addition, not only may tax rates increase, but left alone, the IRA balance could increase as well, resulting in a potential future higher tax rate on a higher IRA balance. That's a double tax problem, at the worst possible time, when funds are needed in retirement.
2. **Achieve better long-term planning**. The second reason why paying the taxes up front makes sense is the long-term benefit. These taxes will be forced out anyway through RMDs, either before or after death. Paying taxes now on a lower balance at a potentially lower tax rate frees up the money to do better long-term planning with permanent life insurance.

In other words, long-term, the family will end up with more wealth than they would have had with the large IRA. And more of that will be tax-free. IRAs should be leveraged, not left alone to grow a tax bill.

The first thing to do is to find out the client's short term needs. That would be for at least 10 years. If all or part of the IRA funds are not needed here, then those funds should be withdrawn and the funds remaining after taxes can be better invested for retirement in a permanent life insurance policy.

Life insurance should be a bedrock of any serious financial, retirement or estate plan, but it is not used nearly as often as it should.

The sweet spot for this transition from IRAs to life insurance is in a client's 60's. Before age 59 ½ there is a 10 percent early distribution penalty and after 70 ½ RMDs begin, limiting some control.

The long-term master plan is for the family to end up building wealth in a permanent life insurance policy, rather than building a tax debt in an IRA. The plan has to be long-term because the funds in the life insurance policy need time to grow.

That should be at least a 10-year plan. The growth will be tax-free within the policy. The best part for clients: The fund is available to double as a lifetime retirement account if needed, except that there are no RMDs and no income taxes.

There is also no stock market risk due to guarantees that can be set up in the policy. There is liquidity and access for lifetime needs. Most clients are not aware of this benefit.

Then, of course, there is the death benefit, which presents an income tax-free windfall for beneficiaries. Life insurance is also a better asset to leave to a trust for beneficiaries if there are control, protection or management issues with beneficiaries. There are no mandatory RMDs from inherited life insurance.

What are the downsides to this plan?

Many say that this is a very unconventional planning technique. It shouldn't be when you see the ultimate family benefit. So what are the potential drawbacks to life insurance vs. IRAs?

The downside is that taxes are paid up front, but much of this money will be going to the tax man anyway over time. There is no tax deduction for contributing to a life insurance policy, but as you can see from the above IRA tax problems, a deduction for an IRA contribution becomes a growing tax debt waiting to be paid.

Also, with life insurance, clients won't benefit from the upside of the stock market, but they also won't lose money, plus they can use other funds for market exposure if they wish. If those investments do produce gains, the appreciation can escape income tax at death with the step-up in basis.

Perhaps the biggest downside is that life insurance is a long-term planning solution that requires payments in the short term for larger benefits long-term. Clients have to focus on the long-term solution under both scenarios: having funds in IRAs or life insurance. At retirement and after death, life insurance wins big and the benefit widens substantially over time, without having to hope the stock market will carry the day.

All this adds up to retirement security and peace of mind, something that large IRAs cannot provide with certainty. Large IRAs need to be transitioned to tax-free territory using the tax benefits of life insurance. Permanent life insurance is a much better long-term retirement asset.

Author's note: *I do not sell life insurance. I am a tax advisor, and as a tax advisor, I can tell you that the tax exemption for life insurance is the single biggest benefit in the tax code. It should be more widely used as both a retirement and estate planning vehicle.*

This newsletter was prepared by Ed Slott 2016. Ed Slott is not affiliated with Wealth Design Group and Mutual Securities Inc.

Gary L. Pevey, CFP, CLU, ChFC
3445 American River Drive, Suite C
Sacramento, Ca. 95864
916-480-0669
gary@wealthdesigngroup.com