

LIFE INSURANCE

VS.

ROTH IRAs

EDSLOTT
AND COMPANY, LLC
America's IRA Experts

Leaving a **Legacy** for Your **Clients** 3 BIG Differences Between Two Planning Vehicles

Leaving a Legacy with Roth IRAs and Life Insurance

Life insurance and Roth IRAs have a basic structure in common. They are both wealth transfer tools that help facilitate an efficient transfer of assets from one generation to the next, and they both can provide a tax-free legacy. Despite their many similarities, Roth IRAs and life insurance are very different, and the rules that apply to one don't always apply to the other. In fact, more often than not, that's the case. Below, we discuss the differences between the two retirement planning vehicles.

#1. Roth IRAs Are Always Included in Your Estate. Thanks to the \$5.34 million federal exemption amount - the amount that can pass estate tax free to beneficiaries - estate tax concerns are nowhere near what they used to be and the overwhelming majority of Americans will not owe any federal estate tax when they die. Still, however, there's a small segment of the population that has to contend with such concerns. Plus, a number of states still impose state estate taxes, and many of those states have set their own exemption amounts much lower than the one available at the federal level. In such cases, life insurance may offer an advantage over Roth IRAs.

Here's the deal in a nutshell. The "I" in IRA stands for individual, meaning it's always yours and therefore, the value of your Roth IRA is always included in your estate. If you are above the federal estate tax exemption or your applicable state estate tax exemption amount, your beneficiaries could end up owing estate tax - at the federal level, state level, or both - on what you thought were "tax-free" Roth IRA assets.

Life insurance, in contrast, can be structured so that it's outside your estate, producing not only an income-tax-free benefit to your heirs, but also one that is not subject to estate tax, regardless of your estate's value when you die. In other words, a truly tax-free benefit. There are a variety of ways to accomplish this, including having an irrevocable trust purchase the life insurance policy or, perhaps, your children or other interested parties. To figure out the best option for you, consult with your insurance advisor, tax professional or estate planning attorney - or better yet, all three!

#2. There's a Limit to the Amount You Can Contribute to a Roth IRA. When it comes to the tax code, there is a giant, gaping, Grand Canyon-esque hole for life insurance. Sure, insurance carriers may limit the amount of insurance they will offer you based on a variety of factors, including your health, annual income and net worth, but that has

absolutely nothing to do with the tax code. As far as Uncle Sam is concerned, you can have as much insurance as you want, or perhaps more accurately, as much as you want and can get. In contrast, if you want to make annual Roth IRA contributions, you are fairly restricted. For 2014, you can contribute no more than \$5,500 (\$6,500 if age 50 or older by the end of the year) to a Roth IRA. You can also convert any existing IRA or eligible retirement plan funds to a Roth IRA, but that assumes you have them already.

In addition, there is no rule on what type of income you need to have in order to purchase life insurance or, for that matter, how much or how little you need to have. Roth IRA contributions, on the other hand, do have such restrictions. Roth IRA contributions, for instance, can only be made with income that qualifies as “compensation,” which is typically earned income. In contrast, life insurance premiums can be paid with any type of income, including interest, dividends and Social Security, all of which are not considered compensation.

If you had no income, you could simply pay for life insurance premiums with your existing assets (although in reality, if you have assets, you are almost certainly going to have some income, even if it’s just interest).

There are also issues on the other side of the spectrum. If you have too much income, from whatever sources, you are prohibited from making any Roth IRA contributions. To see those limits, go to the “IRA and Tax Tables” page at www.IRAhelp.com. With life insurance, there is no limit to the amount of income you can have. In fact, all things being equal, you can generally qualify for more life insurance with a higher income.

#3. There are no RMDs for Life Insurance. When you leave a Roth IRA to non-spouse beneficiaries, such as children, they must generally begin taking RMDs (required minimum distributions) from the inherited Roth IRA no later than the year after they inherit. These distributions are usually tax-free, but they must be taken nonetheless. When beneficiaries inherit life insurance, there are no RMDs to worry about. However, here’s something to consider. While not having to deal with RMDs is nice, that mere fact doesn’t necessarily make life insurance a better option for your planning than a Roth IRA.

Consider the following: when a beneficiary inherits life insurance, the only amount they will receive tax free is the actual life insurance proceeds. If they don’t need the money right away, they might invest the proceeds, but whatever interest, dividends, capital gains or other income those investments generate will be taxable (unless, of course, they are invested in assets that don’t produce taxable income, such as municipal bonds). In contrast, while the inherited Roth IRA will have RMDs to deal with, those amounts may be relatively small.

For example, take someone who inherited a Roth IRA at age 50. In such a case, RMDs would start out at roughly 3% of the account value. The rest of the Roth IRA, however, can be left alone to grow, and that growth can later be distributed tax-free as well. So, whereas a beneficiary of a \$500,000 life insurance policy will only receive \$500,000 income tax free, a beneficiary inheriting a \$500,000 Roth IRA may receive many times that amount in tax-free distributions over the course of their lifetime, particularly if they stick to taking only the RMD each year and no more.

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