Cash Value Life Insurance: Smarter than a Roth?

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We all know the advantages offered by Roth IRAs: the potential for tax-free withdrawals and no required minimum distributions have turned the Roth IRA into a powerful retirement income-planning tool. Unfortunately, the rules governing Roth IRAs can make contributing—and withdrawing—a more complicated and difficult process than is initially apparent, sending many clients on the hunt for additional sources of tax-free retirement income. Enter cash value life insurance, an old planning tool that is experiencing a surge in popularity among clients seeking to maximize their tax-free income during retirement years.

# Cash Value Life Insurance: The Basics

Several types of cash value life insurance exist, but the basic concept is the same: the client pays in premiums to the policy over his lifetime that, over time, are invested by the life insurance carrier and provide a build-up of cash within the policy. Whole life insurance policies generally come with a fixed premium level, while universal life insurance often offers flexible premiums, though the client can always manipulate the premium level based on the amount he wishes to invest in the policy.

In either case, the policy grows based on the interest (or dividends) credited to the client’s account. Indexed universal life insurance policies, for example, are tied to a specific stock index—such as the S&P 500—and provide returns based on market performance. These policies often come with both an earnings cap and an earnings floor, so that, for example, the policy might earn no more than 15 percent, but no less than 2 percent, meaning that the policy can continue to grow even in an economic downturn.

Once the cash value has built up to a substantial level—over a period of years—the client can begin taking tax-free withdrawals to fund retirement. If the client dies prematurely, the policy, of course, still offers a death benefit that will be paid out (also tax-free) to the policy beneficiaries.

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# Measuring up against the Roth IRA

The IRS strictly caps the amount that your clients can contribute to a Roth each year: $5,500 per client in 2015 ($6,500 if the client is age 50 or older). Further, directly contributing to a Roth is limited for clients with annual income that exceeds $183,000 (for a couple; the phase-out for single taxpayers begins at $116,000) and is completely prohibited once a couple’s income exceeds $193,000 (or $131,000 for singles).

As a result, accumulating a substantial Roth IRA nest egg can be difficult based on the relatively low level of annual contributions that can be made. For high-income clients, the process requires a multi-step process that can prove complicated but also generally limits the contribution level. Further, if the client wishes to take a Roth distribution before the occurrence of one of several “triggering events”—such as reaching age 59½ or becoming disabled—the portion of the distribution that exceeds his after-tax contributions will be taxed and the benefit of the Roth will be eliminated.

Cash value life insurance comes without these limitations, though the client will have to wait until the cash value in the policy builds up before taking tax-free withdrawals. This process can usually take ten to fifteen years, but a Roth IRA also requires a five-year waiting period before fully tax-free withdrawals are permitted. Once a substantial cash value has accumulated, clients are free to begin making tax-free withdrawals from the policy even if they have not yet reached age 59½. These withdrawals do not have to be repaid into the policy but simply reduce the policy death benefit.

Clients have the option of purchasing a high value policy; in fact, a client who plans to use cash value life insurance for retirement income planning should plan on keeping the policy well-funded because it is important that the policy remain in force until the client’s death. Allowing the policy to lapse can actually leave the client with a large tax bill, so the client should be advised that this is a long-term planning strategy with potentially significant penalties if the policy is surrendered or lapses.

# Conclusion

Many clients will find traditional retirement vehicles more than sufficient for their retirement planning needs, but for those seeking to maximize tax-free income during retirement years, cash value life insurance can provide an attractive supplemental strategy.