 

LIFE INSURANCE VS ROTH IRAs

Leaving a Legacy

3 Differences Between Life Insurance and Roth IRAs

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 can provide a tax-free legacy. Despite their similarities, life insurance and Roth IRAs are very different, and the rules that apply to one don't always apply to the other. In fact, this is the case more often than not. Below, we discuss the three main differences between these two retirement planning vehicles.

#1. **Roth IRAs are *always* included in your estate.** Thanks to the current $5.49 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. The overwhelming majority of Americans will not owe any federal estate tax when they die. Still, 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 that of 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. This means it's always yours, and the value of your Roth IRA is always included in your estate. If you're above the federal estate tax exemption amount 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.

In contrast, life insurance can be structured so that it's *outside* of your estate. Not only does this produce an income tax-free benefit to your heirs but also one that is not subject to estate tax, regardless of the value of your estate when you die. In other words, it is a *truly* tax-free benefit. There are a variety of ways to accomplish this, including having an irrevocable trust purchase the life insurance policy. To figure out the option that is best 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 hole for life insurance. Insurance carriers may limit the amount of insurance they'll offer you based on a variety of factors, including your health, annual income and net worth. 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, as much as you can get. In contrast, if you want to make annual Roth IRA contributions, you're fairly restricted. For 2017, you cannot contribute more than $5,500 ($6,500 if age 50 or older by the end of the year) to a Roth IRA. You can, however, convert any existing IRA or eligible retirement plan funds to a Roth IRA.

Additionally, there's no rule on what type of income you need to purchase life insurance or how much or how little you need to have. Roth IRA contributions, on the other hand, do have such restrictions. Roth IRA contributions 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 from your existing assets (although in reality, if you have assets, you're almost certainly going to have some income, even if it's just interest).

There are issues on the other side of the spectrum too. If you have too much income, from whatever sources, you are prohibited from making any Roth IRA contributions. To see those limits, click here. With life insurance, there's 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. While not having to deal with RMDs is nice, it 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'll 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 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 minimal.

For example, take someone who inherited a Roth IRA at age 50. RMDs would start out at roughly 3% of the account value. The rest of the Roth IRA can be left alone to grow. That growth can later be distributed tax free as well. A beneficiary of a $500,000 life insurance policy will only receive $500,000 income tax free, while 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.

A Final Thought

If you're looking to leave a legacy to your heirs when you die, there are many tools to consider. Life insurance and Roth IRAs are two of the many options available. In some cases, life insurance may not be available due to poor health. In other cases, such as when your beneficiaries will be in a lower bracket than you are now, there may be a greater net benefit by leaving them larger amounts of tax-deferred accounts, like IRAs, instead of a smaller amount like Roth IRAs. The bottom line is that every situation is different and there's no one-size-fits-all solution. Do your homework, seek competent advice and make a decision that best fits your individual situation and goals.

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