LIFE INSURANCE:
An Alternative to the Backdoor Roth IRA?

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For some, tax-advantaged vehicles—such as traditional and Roth IRAs and 401(k)s—are a great way to save for retirement. But while they may come with tax-deferred or tax-free status, these types of accounts could have some downsides, especially for high-net-worth individuals: either the amount they can contribute is capped or they can't contribute at all due to the amount of income they earn. For 2023, the maximum you can put into a 401(k) is $22,500 ($30,000 if age 50 or older); for an IRA or a Roth IRA, the limit is $6,500 ($7,500 for those 50 or older). And, if you make more than $153,000, you can't contribute to a Roth IRA at all.

While there are ways to circumvent these limits using strategies like the backdoor Roth IRA and mega backdoor Roth (see sidebar on page 2), their future is uncertain. But a lesser-known approach using life insurance may offer similar characteristics to the Roth IRA while providing much-needed tax deferrals. Let's take a closer look at this alternative strategy, how it works, and who might be a good candidate.

Life Insurance: An After-Tax Solution

Life insurance is a tax-efficient vehicle often overlooked by investment advisors. For those who have maximized their contributions—or are ineligible to contribute—to a 401(k) and are looking for another option with tax-deferral features, you may be surprised to learn what benefits life insurance can offer.

Like a Roth IRA, life insurance is funded with after-tax dollars. The account will grow tax deferred and if properly structured, the distributions may be tax-free. It may also provide more flexibility than a Roth IRA, as distributions taken before age 59½ are not penalized.* Something to keep in mind, however, is that life insurance is less flexible in one respect: to maintain the tax-free benefits of life insurance distributions, the policy must remain in place until the insured's death. This may require ongoing premium payments to maintain the policy.

Designing the right policy for you. To allow the cash value to build, life insurance should be designed in a way to provide the lowest death benefit to meet the client's needs, which helps minimize mortality costs in the policy. Different types of policies will affect this cash value in different ways:

- With a universal or whole-life policy, the cash value reflects a stated interest rate or crediting rate.
- With an indexed universal life policy, it is peripherally linked to a market index, and the upside is limited by a declared cap rate.
- With a variable universal life policy, it adjusts based on the market performance of selected investment options.

While universal life policies generally have a floor to protect against market downsides, variable universal life policies will increase or decrease based on the market performance in the selected investments without a floor.

Accessing cash through withdrawals and loans. To provide for cash needs or a stream of income in retirement, policy owners may withdraw an amount up to the policy's cost basis or borrow the money through a policy loan. Before initiating a distribution, evaluate the policy's stability to ensure that there is sufficient cash value to maintain it based on projections. If the policy lapses, gains may be taxed as ordinary income. Note that the policy may have rules or limits on how much can be withdrawn to maintain the preferred tax treatment of withdrawals and the tax-deferred growth of the policy.

When borrowing money from the policy, repayment of the loan principal or the annual interest is optional, and unpaid interest is added to the principal. If the borrower fails to repay the loan before death, the money is simply withdrawn from the policy's death benefit before being distributed to the beneficiaries.

Since there are no guarantees on the cash value or the amount being withdrawn from the policy, ongoing monitoring and management of investment options will be crucial to ensure that the policy continues to meet your goals and objectives.

Extra costs may be a deterrent. One drawback to the permanent life insurance strategy is that it has additional costs not found in retirement accounts. The biggest expense is the death benefit feature. For those who need death benefit protection, this cost may be justifiable. But be aware that the cost is not comparable to term insurance. Term insurance is priced for the probability of death during the term (10 or 20 years) of the policy. With permanent insurance, there is a greater expectation that death will occur while the policy is in force.

The best way to evaluate the benefits of a permanent life insurance policy is to request an illustration from an insurance carrier. A product specialist can compare several policies to help you select the best design for you.

What You Should Know About the Backdoor and Mega Backdoor Roth Strategy

Individuals who earn too much to contribute to a Roth IRA or to make tax-deductible contributions to a traditional IRA can fund a Roth IRA in a few ways:

Tax-free conversion

Those without an existing IRA (this includes SEP, SIMPLE, and rollover IRAs) can make a nondeductible contribution to a new traditional IRA, then convert it to a Roth IRA tax free if it's done before there are any earnings in the account.

Pro rata conversion

Clients may be subject to the pro rata rule if there is both pre-tax and after-tax money in any existing IRAs. The rule requires that both are included in the conversion, based on the percentage share of each held in existing IRAs.

Mega backdoor Roth

When after-tax contributions are made to a 401(k) plan, they can then be rolled into a Roth IRA or converted within the plan to a Roth 401(k), if certain conditions are met. This could get complicated if the account has any pretax earnings on the after-tax contributions.

Who Benefits from a Life Insurance Policy?

Often, individuals looking for tax-efficient ways to save for retirement—such as high-income S corporation or LLC owners—find fewer opportunities to do so because of the pass-through taxation of these organizational structures. When faced with qualified plan limits and the unavailability of nonqualified plans, they either must pay taxes on their income or spread their profits among employees to get a tax deduction.

By obtaining life insurance, these business owners can help provide for their families in times of need. In addition to providing a way to access funds in case of disability or limited cash flow, it may also help provide liquidity to pay estate taxes for high-net-worth clients if the policy includes a tax-free death benefit.

What about the Roth 401(k)? Individuals whose employers offer the Roth 401(k) option may wonder if shifting some of their 401(k) contributions to the Roth 401(k) is a good alternative. The answer can be complicated and rests on several factors, including whether they can pay taxes on contributions out of pocket, their expected tax bracket at retirement, and if the traditional 401(k) employer match has been maximized. If you are attracted by the features of the Roth 401(k) and want to take maximum advantage of it, but tax considerations are not favorable, you may want to pursue a permanent life insurance policy.

Let Us Help You Find the Right Solution

For those individuals who have maxed out contributions to their retirement account, or are ineligible to contribute at all, there are many options available. But there are a lot of variables at play when thinking about which route to take.

**The policy must be properly structured and managed to avoid penalties; distributions from modified endowment contracts are subject to tax rules and penalties similar to annuities. In addition, withdrawals and loans lower both the cash value and the death benefit.*

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