



Roth IRA Alternative
Maximum Funded IUL

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1. Roth IRAs - *How they work*:

- a. Roth IRAs are a phenomenal tax-planning tool, with "*a catch*"
- b. Contributions are made on an after-tax basis
- c. All appreciation in the account is tax-deferred
- d. Unlike Traditional IRAs - distributions from a Roth are "TAX-FREE"
- e. No Required Minimum Distributions (RMDs) for Roth IRA owners
- f. Paying tax "on the seed" and getting "the harvest" for free!

2. Roth Limitations/Restrictions:

- a. *Annual Income Restriction* - if married, MAGI cannot exceed \$193,000, if single MAGI cannot exceed \$137,000¹
- b. *Contributions limits* - \$6,000 per individual of *earned income*; including a non-working spouse, plus a \$1,000 catch-up for taxpayers age 50 and up
- c. *The Catch*:
 - ⇒ Those that have the wherewithal to fund a Roth IRA are often limited by the income restriction
 - ⇒ Those who are not restricted by the income limitations are often unable to contribute to a Roth due to limited income and an inability to save
 - ⇒ What options do high-income earners have?

3. Roth Alternative - "Retirement Life/Max-Funded IUL":

Summary: The major hurdle clients must clear to benefit from this strategy is to dispel the longstanding notion that life insurance cannot be used to efficiently accumulate value. This strategy uses or "borrows" the life insurance chassis as the funding mechanism for several reasons, most important are the tax-favored benefits offered by cash value life insurance including tax-deferred accumulation, tax-free death benefit, and tax-free policy loans. Furthermore, using the Max-Funded IUL strategy as a Roth Alternative, high income earners are not faced with the income restrictions or funding limitations that make funding a Roth IRA impossible.

Historically, accumulating assets inside a life insurance policy has been difficult due to matter in which cash value accumulated, which has been directly linked to the issuing company's general assets and thus, conservative investments that are inherent in the insurance industry. Further restricting competitive growth inside a life insurance policy are the mortality and administrative costs associated with the "traditional" use of cash value life insurance. Most life insurance is purchased with the maximum death benefit being the primary objective, which results in higher mortality costs. Most insurance

¹ As per the 2019 IRS Guidelines

buyers willingly and regularly trade off cash value accumulation for death benefit, and rightfully so, if death benefit is the driving force behind the decision to purchase life insurance in the first place. Term life insurance is a perfect example of the trade-off between sacrificing cash value accumulation - *there is none* - for death benefit!

Determining Premium Levels: It is important to note how premiums are calculated and which entities govern *how much or how little* premium can be paid into a life insurance policy. The life insurance companies themselves determine the *minimum* premium that must be paid into a life insurance policy to maintain a specific death benefit at a certain age and health status, a perfect example being a ten-year level term policy that provides maximum death benefit for the least amount of cost.

The IRS governs the maximum amount one can pay into a life insurance policy. The Federal Tax Code determines the *maximum* amount of premium that can be paid into a life insurance policy under IRC Section 7702. This tax code provides various testing to determine if premiums exceed the maximum amount that can be paid into a life insurance policy. The intent of the Max Funded IUL strategy is to fund a policy up to the "*maximum guideline premiums*" outlined in the tax code to take full advantage of the numerous tax benefits available in cash value life insurance.

The challenge: The goal of this strategy is to maximize the cash value accumulation by minimizing the internal expenses that historically restrict the growth inside cash value life insurance. The greatest expense of which is the mortality expense, essentially the "term costs". Understanding how mortality expenses are assessed is critical to understanding the strategy:

- a. In a universal life insurance policy, the company assesses mortality costs by determining the amount "at risk" to the company, which is the difference between the face amount and accumulated value. Simply put, if the face amount of the policy is \$1,000,000 and the cash value is \$200,000, the amount "at risk" to the insurance company is \$800,000. A company will assess mortality cost only on the \$800,000 and not the full \$1,000,000 in this scenario.
- b. The goal is to minimize the amount "at risk" to the insurance company by structuring a contract/policy that will emphasize cash value accumulation with little or no regard to the death benefit. It is important to emphasize, though this strategy will provide a tax-free benefit to the chosen beneficiary, the amount of death benefit provided in this strategy should not be a relevant factor when considering this strategy.

Managing Costs: In a maximum funded "indexed universal life" (IUL) contract, the mortality costs will represent, as a percentage, a small fraction of the overall value inside the policy. The policy gains value overtime as 1) additional premiums are contributed and

2) as interest is credited to the contract. Over time, the mortality costs become "diluted" as they represent a smaller fraction of the overall policy value each passing year.

- ❑ *For example:* If the accumulation value of a policy is \$500,000 and the death benefit is \$1,250,000, the amount at risk to the insurance company would be \$750,000. If the annual mortality costs were \$3,500, the mortality costs as a percentage of the total *cash* value would be .70% or 70 bps, less than the operating expense than the majority of actively managed equity mutual funds.

Tax Benefits: The tax benefits offered by life insurance are significant and include the following:

1. *Tax-Deferred Growth* - The cash value of a life insurance policy is not subject to current taxation as it accumulates.
2. *Tax-Free Death Benefit* - The death benefit is income tax-free to the beneficiaries, though if the policy is owned by the insured it will be included in his/her taxable estate and may be subject to estate tax².
3. *Tax-Free Withdrawals* - If a policy meets IRC premium guidelines and not considered a MEC (Modified Endowment Contract), withdrawals from the policy are not taxed until the total withdrawals exceed the premiums paid, or basis.
4. *Tax-Free Policy Loans* - It is possible to take distributions from a policy that exceed basis if taken as policy loans. As long as the policy does not lapse and policy loans are paid back from the death benefit. Policy loans can be an extremely effective method of taking distributions from a life insurance policy.

Earnings/Interest Credits: The manner in which interest or earnings are credited to the an indexed universal life insurance contract is what distinguishes this strategy from others that have been used in the past, like using traditional universal life or whole life policies whose crediting methods are directly linked to the general assets of the life insurance company. Subsequently, the earnings in the traditional policies are limited to the low rates of return offered by investment grade fixed income investments, the most widely held asset by most highly rated insurance companies.

The interest credited to an IUL contract is directly linked to an underlying index, or blended index. For simplification, assume that the linked index is the well known Standard and Poor 500, or S&P 500, sans dividends. This index, including dividends, historically has averaged roughly 11.5%³, much greater than fixed income investments.

² If the policy owner is interested in the tax-free income offered by this strategy, it may be difficult to exclude the proceeds from the estate. Please consult a tax attorney

³ The average rate of return of the S&P 500 from 1928 to 2018 according to research completed by NYU was 11.36%

It is important to note, that a direct investment in an index is not made by the policy owner, the insurance company simply credits interest that is linked to a corresponding index selected by the policy owner annually from a list of available crediting methods, i.e., indices.

Most insurance companies will "cap" the interest credit for each contract year. Current caps vary from company to company and range from 8% to 16% to uncapped strategies⁴. The caps will adjust upward and downward, depending on two factors, 1) current interest rates and 2) market volatility, the second of which directly impacts the price of the underlying options used to "fund" the contracts.

- ❑ *For example:* Assume that the policy earnings are "linked" to the S&P 500 and that the index return for the policy year was 8%. If the policy value was \$500,000, the earnings credited to the contract for that year would be \$40,000.
 - Using the morality example given previously, if the mortality costs were \$3,500, the net gain for the contract year would be \$36,500 (\$40,000-\$3,500), or 7.3%.

Protection against Loss of Principal: It is important to emphasize that if the underlying index return for the corresponding time frame is *negative* than no interest is credited to the contract value for that contract year. Therefore, other than a reduction from mortality and other expenses, the principal is not impacted in a year when the index return is negative. The reason this is possible is as follows:

- ❑ The life insurance company takes the interest earned on the general assets used to back the life insurance values and purchases "call options" on the various indices. Understanding how options work, if the index return is positive, the option is "in the money" and the earnings from the option are allocated proportionately to each contract. If the index return is negative for the policy year, the option expires with no value and no interest credits are applied for that contract year. This is a very simple explanation to a more complex investment strategy used by the insurance companies to fund these IUL contracts.

Policy Loans - Interest Credits: The tax-free policy loans are the key to making this concept work. It is extremely important to select a company that offers a "fixed rate" loan that is written into the contract. It is also important to select a company that offers "*participating*" loans. A participating loan will credit the loaned, or borrowed amount, with the same interest credit as the remaining cash value receives. We cannot emphasize the magnitude of selecting a company whose products offers *both* fixed interest rates and participating policy loans.

⁴ Caps vary from company to company and will also vary depending on the underlying index selected

- *For example:* If the total cash value is \$500,000 and the loan amount is \$300,000, the total interest credited in a year when the index return is 7%, assuming a 5% fixed interest rate, would be as follows:
 - Cash Value Portion - $\$500,000 \times 8\% = \mathbf{\$35,000}$
 - Loaned Amount - $\$300,000 \times (7\% - 5\%) = \mathbf{\$6,000}$
 - Total interest credit: \$41,000
 - If the index was negative for the year, no interest would be credited, and \$15,000 of loan interest would be debited against the policy value

4. **How it works:**

- a. Determine the amount of funds you want to allocate annually to the strategy and for how long you want to contribute
- b. Given age and health status, purchase the *minimum* amount of death benefit allowed using the IRC Premium Guidelines
- c. The plan is funded with “after-tax” dollars, like a Roth IRA as rapidly as possible without creating a MEC, typically five to ten years.
- d. The plan assets accumulate on a tax-deferred basis
- e. The primary costs associated with the plan are the mortality costs, which are “diluted” as a percentage as policy values grow
- f. The plan assets are tied to a single or blended index and may be capped, or uncapped depending on the strategy selected, which can change annually
- g. Plan values are 100% protected from market decline
- h. Distributions taken as a policy loans from the plan are “tax-free” and can be taken at anytime and used for any purpose, i.e., college funding, major purchases, retirement, etc.
- i. There are no tax penalties if distributions are taken prior to age 59 1/2 unlike most retirement plans, as this strategy is not subject to the IRS guidelines governing qualified plans (401(k), 403(b),) and IRAs
- j. The plan is self-completing in the event of death