Large IRAs are in fact poor retirement vehicles

Retirees want guarantees, growth, control, safety, protection, access, liquidity and low taxes. Here's how to do all of that.

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The IRA problem

If possible, debt should be eliminated before retirement. Retirees who are debt-free are proud of that fact. To most people, being debt free means having no more home mortgage, having no credit card debt and not owing any money to anyone.

But if you have a large IRA or other tax-deferred retirement accounts, you have a looming debt to the IRS. As that IRA grows so does that debt, just like an unpaid credit card, compounding as the account value increases.

While the tax debt is deferred, the deferral is limited due to required minimum distributions (RMDs) that force the taxes out with withdrawals beginning after age 70 ½. The problem with this retirement debt is the tax rate on future IRA withdrawals is **unknown**.

That creates uncertainty, especially when it is likely that tax rates will increase. And they will be based on a larger balance the longer the IRA is left to grow tax-deferred.

Unlike other non-IRA type investments, funds in IRAs and 401(k)s at death remain taxable. There is no step-up in basis, as there would be for a highly appreciated stock held outside of an IRA, eliminating the income tax at death. IRA and 401(k) beneficiaries are subject to tax on post-death RMDs.

In addition, if the estate including the IRA is large enough, the IRA can be subject to estate taxes as well. In that case, there is a corresponding tax deduction (the deduction for income in respect of a decedent), but only for federal estate taxes, not state estate taxes.

IRA funds are often invested in the stock market, so they are also subject to market risk. Traditionally, the stock market increases over time. But if the market declines when retirement funds are needed, less of the remaining funds are available for future growth. This is the classis sequence of stock market returns that deplete needed retirement funds.

On the contribution side, annual IRA contributions are limited to small amounts ($5,500 per year or $6,500 for those ages 50 and over). Plus, contributions for traditional IRAs are no longer permitted once the client reaches age 70 ½.

For these many issues, it is apparent that large IRAs are in fact poor retirement vehicles. There are too many risks and uncertainties which do not make a good foundation for a long-term retirement plan.

When asked, most people approaching or in retirement want more certainty. They also want guarantees, growth, control, safety, protection, access, liquidity and low or **no taxes**.

2 good reasons to move IRA funds to high cash value life insurance

Everyone wants peace of mind. Large IRAs will not provide that, but these IRA funds can be leveraged to gain *all* of that by transitioning those funds to a high cash value life insurance policy. When IRAs grow too much, they need to be trimmed. Yes, that means paying taxes upfront, but there are two benefits to this.

1. **Take advantage of low tax rates.** One is that tax rates right now are as low as they may ever be. In addition, not only may tax rates increase, but left alone, the IRA balance could increase as well, resulting in a potential future higher tax rate on a higher IRA balance. That's a double tax problem, at the worst possible time, when funds are needed in retirement.

2. **Achieve better long-term planning**. The second reason why paying the taxes up front makes sense is the long-term benefit. These taxes will be forced out anyway through RMDs, either before or after death. Paying taxes now on a lower balance at a potentially lower tax rate frees up the money to do better long-term planning with high cash value life insurance.

In other words, long-term, the family will end up with more wealth than they would have had with the large IRA. And more of that will be tax-free. IRAs should be leveraged, not left alone to grow a tax bill. The first thing to do is consult with your retirement planner to determine your short-term needs. That would be for at least 10 years. If all or part of the IRA funds are not needed here, then those funds should be withdrawn and the funds remaining after taxes can be better invested for retirement in a high cash value life insurance policy.

The sweet spot for this transition from IRAs to life insurance is in your 50's, 60's, and early 70's.

The long-term master plan is for you to end up building wealth in a high cash value life insurance policy, rather than building a tax debt in an IRA. The plan can either be long-term or short term because all the funds in the life insurance policy are linked to powerful index strategies.

The growth will be tax-free within the policy. The best part is that the funds are available to double as a lifetime retirement account if needed, except that there are no RMDs and ***no income taxes***.

There are also no stock market risks or losses, due to guarantees that are built into the policy. There is liquidity and access for lifetime needs, such as tax free non-reportable income which could result in a lower tax bracket, reduced income tax bill, and reduced taxes on Social Security benefits.

Reasonably speaking, one would be funding the life insurance policy using monies which would otherwise be paid to the IRS in taxes.

Then, of course, there is the death benefit, which presents an income tax-free windfall for beneficiaries. Life insurance is also a better asset to leave to a trust for beneficiaries if there are control, protection or management issues with beneficiaries. There are mandatory RMDs from inherited IRA accounts, in contrast the death benefit from a high cash value life insurance policy is tax free.

What are the downsides to this plan?

Many say that this is a very unconventional planning technique. It shouldn't be once you see the ultimate benefit to you and your family. So, what are the potential drawbacks to high cash value life insurance vs. IRAs?

The downside is that taxes are paid up front, but much of this money will be going to the tax man anyway over time. There is no tax deduction for contributing to a life insurance policy, but as you can see from the above IRA tax problems, a deduction for an IRA contribution becomes a growing tax debt waiting to be paid.

Perhaps the biggest downside is that high cash value life insurance is a long-term planning solution that requires payments in the short term for larger benefits long-term. You should focus on the long-term solution under both scenarios: having funds in IRAs or life insurance. At retirement and after death, high cash value life insurance wins big and the benefit widens substantially over time, without having to hope the stock market will carry the day.

All this adds up to retirement security and peace of mind, something that large IRAs cannot provide with certainty. Large IRAs need to be transitioned to tax-free territory using the tax benefits of high cash value life insurance. As you can see, high cash value life insurance is a much better long-term retirement asset.

Note from Ed Slott: *I do not sell life insurance. I am a tax advisor, and as a tax advisor, I can tell you that the tax exemption for life insurance is the single biggest benefit in the tax code. It should be more widely used as both a retirement and estate planning vehicle.*