Using life insurance to fund retirement… has many benefits

While tax-qualified retirement plans allow an individual to avoid taxes through retirement, heavy taxes are taken out after. A "tax free" insurance based plan can maximize your investment over time by allowing taxes to be taken on the "seed" instead of the "crop."

Editor's note: The "tax free" life insurance savings plan discussed here requires the investor to put a small seed investment into a large life insurance policy and then take out loans against the policy during retirement to pay for basic needs. The investor can use the interest on loans such as these as a tax deduction, making the loans essentially tax-free.

Due to the differing opinions of investment professionals on this subject, Citizens recommends that you investigate carefully before choosing any retirement plan.

by Bart S. Croxford CPA Sandy, UT

I would like to respond to the article published in the Aug. 28 edition of the Citizens section by Thomas McCarthy.

I do not know what financial expertise he possesses but I strongly disagree with his views on retirement. Chances are that he has not "run the numbers" to prove his point. He made assertions but did not back them up with facts and figures. I would like to show with my graphs backed up by a spreadsheet that he is wrong to say that retirement should not be funded with life insurance.

I used to share McCarthy's views, but I was convinced that I was wrong when I saw the numbers. In fact, he would be right if it weren't for income, estate and social security taxes.

He wrote about inflation and future tax rates. He is right that inflation will eat into a retirement plan, but it eats into a tax-qualified plan just as much, or more than it does a tax-free plan. He assumes that a retiree's tax rates will decrease, but if they don't, he will really be in trouble, and I don't think anyone is going to believe that tax rates will truly decrease in our lifetime.

Even President Reagan's supposed tax cut in the early 80's didn't last long. In fact, according to recent newspaper articles, he is now accused of authoring a bigger tax increase than President Clinton did a few years ago. McCarthy wrote that the top tax bracket in 1960 encompassed more people than it does today, but I fail to see what the top tax bracket in 1960 has to do with anything. Most retirees won't be in the top tax bracket anyway and we all know how hard the middle class has been hit with taxes for many years.

I have never seen anyone who promotes tax-qualified plans run the figures through retirement. They run the figures to age 65 or beyond and show how much more you can accumulate if you use a tax-qualified plan, such as an IRA or 401(k) and defer your taxes until retirement. But in savings as in sports, it's the final score that counts, not the score at half time or even after three quarters.

The real clincher in the whole plan is the fact that with tax-qualified plans, one must pay taxes on the entire amount taken at retirement, including the growth, which accounts for the largest portion by far, whereas on tax-free plans, one pays no taxes on the growth at all. In other words, one can be taxed either on the seed or the crop. With tax-qualified plans, one pays on the crop and on tax-free plans, one pays on the seed. One does not receive the tax deduction now, but instead receives a far greater benefit by not having to pay taxes on the amount received at retirement.

The benefits are enhanced when one considers that an individual using a tax-free plan will receive more social security benefits because reportable taxable income will be much lower. Also, the user can choose a higher payment pension plan, which ceases at his death (if his employer provides one) because he has life insurance if he dies. Most retirees choose a lower option to allow their spouses to continue receiving pension proceeds after they die. It is also a much more advantageous option for estate planning, because the insurance death benefits pass to heirs tax-free (if properly planned), But the qualified plan will lose 70-90 % due to income and estate taxes.

Even if an employer matches its employee's contributions dollar for dollar, it still doesn't come close to touching a tax-free plan's payout based on investment. In fact, in the graph, I assumed the employer matched the employee's contributions 100%. Besides this, the qualified plan has many restrictions and penalties: if you take money out too soon, you are penalized: if you leave it in too long, you are penalized: if you accumulate too much, you are penalized. Basically, the IRS is a terrible partner to have for retirement.

The spreadsheet and graphs I have developed prove my point. They compare a qualified plan, such as a 401(k), with a tax-free plan, such as an indexed universal life policy. I have assumed that on the qualified plan, one can earn a 12-percent return annually and a 10-percent return on the tax free plan because about two percent would go to insurance cost and loads.

Notice that the accumulation isn't nearly as great on the tax-free plans, but it lasts much longer because one can take loans against the policy tax-free. In fact, one is almost 4 million dollars better off if he or she lives to age 95 because instead of depleting the account, it keeps growing, even though the net amount enjoyed by the retiree is exactly the same ($108,560) in both cases.

I used to feel the same way Mr. McCarthy does, but when I looked at the whole picture, including initial taxes and taxes through the withdrawal period, it made much more sense to use life insurance to fund retirement.

IUL -vs- Tax Deferred IRA (401k) -vs- Roth IRA

$3,600 per year or $300/month ($345/ month if Tax Deferred)

7.9% Annual Interest Rate for 35 Years (Until Age 65)

	Total Investment (35 years)	Gross Cash Value @ age 65	Gross Annual CASH FLOW (Living off just Interest)	Taxes @ 30% (*2)	**Total NET Annual Cash Flow (age 65)**	**Total NET Cash Flow by age 80**	**Total NET Cash Flow by age 90**	**Total NET Cash Flow by age 100**	**DEATH BENEFIT**	**TOTAL POTENTIAL BENEFITS by age 80**	**TOTAL POTENTIAL BENEFITS by age 110**
Tax Deferred IRA-401k	$144,900	$697,703	$55,119	-$16,536	$38,583	$578,745	$964,574	$1,350,404	$0	$578,745	$1,736,234
ROTH IRA	$126,000	$606,698	$47,929	$0	$47,929	$718,937	$1,198,229	$1,677,520	$0	$718,937	$2,156,811
IUL	**$126,000**	**$512,307**	**$65,363**	**$0**	**$65,363**	**$980,445**	**$1,634,075**	**$2,287,705**	**$400,000**	**$1,380,445**	**$11,457,510**

*1. Roth IRA limited to $3,000 Annual Investment (Increasing to $4,000 & $5,000 in years to come, making this annual amount impossible to do with a Roth IRA, unless done through a series of rollovers)

*2. 10% Early withdrawal Penalty applies to withdrawals made prior to age 59 1/2, potentially increasing to age 62, 65, etc. Principal invested may be withdrawn from Roth without Penalties or taxes.

***The values on this sheet reflect all fees, sales charges, costs, etc. of the IUL. No fees, sales charges, costs, etc. were deducted from either standard or Roth IRA.**

*The tax advantages of the IUL are similar to a Roth, in that they are not tax deductible up front, but the interest earned and the cash flow taken out are not taxable as ordinary income.