IRA-TO-IUL CONVERSION STRATEGY:

WHAT TO CONSIDER

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Converting retirement funds from a tax-deferred status to a tax-free status is nothing new. Over the past decade, more and more Americans – helped by financial professionals – are realizing deferring taxes may not be in their best financial interest.

In the past, many traditional IRAs were converted into tax-free Roth IRAs. Today, funds from a growing number of IRAs are being placed in indexed universal life (IUL) insurance policies. And it's easy to see why: IUL can provide four powerful benefits to today's savers:

- The *power of indexing* – growth potential with protection from market losses[1]
- *Tax-free income* through policy loans[2]
- Access to funds with no *market-value adjustment*
- A *legacy for beneficiaries* above the account value

[1] *Indexed universal life is not a registered security or stock market investment and does not directly participate in any stock or equity investments, or index. The index used is a price index and does not reflect dividends paid on the underlying stocks.*

[2] *Policy loans and withdrawals are not usually subject to income tax unless the policy is classified as a modified endowment contract (MEC) under IRC Section 7702A. Policy loans and withdrawals will reduce available cash values and death benefits and may cause the policy to lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change; consult a tax professional about your personal situation.*

Thanks to these benefits, IUL has become a key component of holistic planning for a growing number of Americans. Financial professionals understand that IUL can deliver a package of features not found in other financial vehicles.

What is an IRA-to-IUL conversion?

An IRA-to-lUL conversion is a process by which you withdraw a portion of your IRA funds, pay taxes on the proceeds and use the net amount to purchase a permanent life insurance policy that builds cash value.[3]

You may be familiar with the term "IRA rollover," which describes transferring funds from one IRA account to another. You may also be familiar with the term "Roth conversion," which describes moving funds from a qualified account to a tax-free Roth account.

An IRA-to-lUL conversion is neither of these approaches, but shares some commonalities with each. Like an IRA rollover, an IRA-to-lUL conversion moves funds from one vehicle to another. Like a Roth conversion, an IRA-to-lUL conversion involves paying taxes now on assets moved from a tax-deferred account to a tax-free vehicle.

An IRA-to-lUL conversion can be part of a holistic planning approach to help maximize and balance the growth potential, risk and tax efficiency of your overall retirement portfolio.

Is an IRA-to-IUL conversion strategy sound?

The answer is yes, with important qualifications.

Like many financial strategies, IRA-to-lUL conversions can be beneficial for some, while not appropriate for others. Additionally, as with any insurance strategy, proper structuring of the policy is critical to help ensure your goals and objectives for purchasing the policy are met.

[3] *Permanent life insurance policies require monthly deductions, which include cost of insurance, expense charges and potentially other charges. These deductions may reduce the cash value of the policy.*

At its core, an IRA-to-IUL conversion strategy is a two-step decision-making process:

1. Does it make sense for you to save in a tax-deferred vehicle or a tax-free vehicle?
2. If the answer is a tax-free vehicle, is IUL the right tax-free vehicle?

There are six key areas to consider prior to moving forward with this approach. Reviewing each of these areas can help you determine if this approach is right for you, and how to best execute the strategy.

#1 Are you a good fit for this strategy?

Most of the time, an IRA-to-IUL conversion strategy is not appropriate for your entire IRA account balance. So make sure this strategy is a good fit for you before allocating any portion of your IRA to an IUL policy.

- Funds in an IUL policy need time to accumulate. Therefore, an IRA-to-IUL conversion should only be used for the portion of your IRA that is not needed for income in the next 10 years.
- Life insurance policies require medical, and possibly financial, underwriting to determine eligibility.
- Remember: an IRA-to-IUL conversion should be just one piece of your retirement planning strategy.

#2 Analyze your IRA to make an informed decision

How do you know if an IRA-to-IUL conversion will improve your retirement approach? Start by analyzing your current IRA. Important things to consider include:

- *Total tax liability:* How much in taxes will the IRA generate over your lifetime? Based on this analysis, your financial professional can help you decide if moving IRA funds from a tax-deferred to a post-tax status makes sense.
- If the answer is yes, you can analyze:
    – *After-tax growth potential:* Using reasonable assumptions for growth and taxation, what would the post-tax IRA value be in 10, 20 and 30 years?
    – *Less favorable market growth:* What would happen to the IRA value if market performance is less favorable than assumed?

#3 Compare the IRA analysis to an IUL illustration

Working with your financial professional, compare after-tax growth in your IRA to after-tax growth in an IUL policy. Together, you can evaluate the results.

#4 Handle taxes responsibly

You will owe taxes on the funds coming out of your IRA. In order to determine the best approach for paying those taxes, you should consult with a qualified tax advisor.

- IUL premiums should be set using post-tax amounts from an IRA.
  - For example, Bob withdraws $50,000 from his IRA this year and has a 25% tax liability. His IUL premium for this year should be $37,500 ($50,000 x .75).
- You should not use IUL policy loans to pay taxes.
  - For example, Bob should not pay an IUL premium of $50,000 this year, and then take a policy loan for $12,500 to pay the taxes owed.
  - Using policy loans to pay taxes puts your IUL policy at risk. Early-year loans can stress an IUL policy, particularly if indexing interest credits are lower than expected.

A sound IRA-to-IUL conversion strategy will handle taxes outside the IUL policy, and then compare growth in the IRA and IUL using the net-of-tax premiums and values.

This is a hypothetical example provided for illustrative purposes only; it does not represent a real-life scenario and should not be construed as advice designed to meet the particular needs of an individual's situation.

#5 Funding the IUL policy

It's important to fund your IUL policy in an efficient way. This means balancing two interests:

- Getting funds into the IUL policy quickly, to maximize accumulation.
- Ensuring the premium pattern does not cause the IUL policy to become a modified endowment contract (MEC), as loans from a MEC are not tax-free.[4]

A 5-pay premium[5] is generally the ideal structure for an IRA-to-IUL conversion strategy.

- A 5-pay moves premiums into the policy quickly while helping ensure the policy does not become a MEC.
- It also distributes the impact of paying taxes on withdrawn IRA funds over more years, compared to a more rapid funding pattern.
    – In some cases, a 7-pay or even a 10-pay may be appropriate to avoid moving into a higher tax bracket in any given year.

#6 Death benefit

The death benefit is an important consideration. After all, an IUL policy delivers something an IRA does not: A legacy above and beyond the account value. In fact, death benefit protection is the primary purpose of life insurance.

- Depending on your situation and needs, it may make sense to set the death benefit at the minimum allowed by IRS guidelines.
    – This minimum death benefit will ensure the policy does not become a MEC, and the tax status of your funds will not be at risk.
- You should not dramatically lower the death benefit after the first few policy years. Doing so risks making the policy a MEC.
    – If you choose to lower the death benefit in future policy years, be sure the reduction does not result in a death benefit less than the total amount of premium paid.

[4] *A MEC policy is one in which the life insurance limits exceed certain high levels of premium, or the cumulative premium payments exceed certain amounts specified under the Internal Revenue Code. For policies that are MECs, distributions during the life of the insured, including loans, are first treated as taxable to the extent of income in the contract, and an additional 10 percent federal income tax may apply for withdrawals made prior to age 59 ½.*

[5] *A 5-pay premium describes how you will fund the IUL insurance policy: with premium payments over 5 years. Likewise, a 7-pay or 10-pay references funding the IUL policy with premium payments for those given year durations.*

Should you consider an IRA-to-IUL strategy?

IRA-to-IUL conversions are growing in popularity for good reason. If you are approaching retirement or are already retired and looking for:

- Death benefit protection
- Potential for growth with protection from market losses
- The ability to diversify your retirement assets
- The tax advantages of a properly structured life insurance policy

you may want to consider an IRA-to-IUL conversion.

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