



# Life Insurance

## Shields Your Clients Against Roth Conversion Tax

BY DAVID FREITAG

Many reasons compel consumers to consider the conversion of a traditional qualified retirement account to a Roth IRA. The advantages of tax-free income, no required minimum distributions (RMDs) for the owner or spouse and no IRD taxes to be paid by nonspousal beneficiaries are powerful motivators to convert. However, these Roth IRA advantages come with a real cost: the taxes due on conversion. If the conversion amount is large, the required tax payments can be prohibitive.

For those couples who find the Roth IRA conversion very attractive, but too costly to implement today, there is an alternative. That alternative is life insurance. Adding a life policy into the Roth conversion discussion offers great flexibility and increased control.

The conversion would be put off until the death of a spouse, at which point the surviving spouse can opt to make the Roth conversion and pay the tax with the life insurance proceeds. Then the

surviving spouse would be able to take Roth IRA distributions tax-free. So, the couple would have taken advantage of the special tax treatment of both IRA products while covering the tax impact with life insurance.

### Costs of Roth IRA Conversion

To really get a handle on the conversion cost, let's first look at a scenario of a traditional IRA valued at \$500,000. In 2010, a married couple making \$200,000 per year in taxable income with itemized deductions of \$45,000 and two personal standard exemptions might expect to pay +/- \$65,000 in federal taxes. This number includes income, Social Security and Medicare taxes.

When you add a one-time \$500,000 taxable income event to this scenario due to the IRA conversion, the taxes increase to more than \$245,000.

This conversion represents a federal tax increase of \$180,000. Furthermore,

this does not include any adjustments for state or local income taxes. In Massachusetts, as an example, the state income tax (5.3 percent) on this conversion would add another \$26,500 to the "cash needed to convert" column at the end of the year. This means that our couple would need over \$206,000 in liquid assets to convert their traditional IRA to a Roth IRA. Couples living in higher-tax states such as New York, New Jersey and California could expect this tax bill to be even worse.

### Where Does Life Insurance Fit In?

The legendary Ben Feldman called life insurance "The Miracle of Pen and Ink." Life insurance is truly a remarkable product. It creates money that is delivered to a surviving spouse exactly when it is needed the most. Plus, these funds are always delivered at a cost of "pennies on the dollar." Using life insurance as a planning tool to pay income taxes for a Roth conversion is a good

strategy, and it offers additional flexibility in a world of uncertainty over taxes and changing life needs.

Assuming a couple purchases life insurance with the plan of paying income taxes for a Roth IRA conversion, what happens upon the owner's death? The surviving spouse, in this case, may roll over the owner's qualified plan to a spousal IRA. The spousal IRA is then converted to a Roth IRA. Using the life insurance proceeds, the surviving spouse can pay the taxes due on the conversion. This keeps the entire amount of the IRA intact. As a result, more tax-qualified money is converted into a Roth IRA, which means more tax-free income for the spouse and more tax-free income for children or grandchildren.

In addition, the face amount of the life policy can be tied to the projected RMD that will be forced out of the qualified plan when the owner reaches age 70½. For most couples, this RMD calculation is easy to do. Just divide the expected balance of the qualified account by the Uniform Life Table factor of 27.4 for the first

premium of approximately \$7,000, she would qualify for \$302,302. By using about half the eventual income generated by the RMD force-out, the life policy can provide enough money to pay the conversion tax at her death plus more for surviving children, grandchildren or legacy giving.

### A Low-Cost Way to Postpone a Decision

Setting up a life policy to pay Roth conversion tax has another advantage as well. For a very low cost, it allows the decision on the Roth conversion to be postponed. It is very possible the income tax rules will change in the next few years. The income tax rules for 2010 are known. The percentages are set and the tax rates are locked down. In contrast, the income tax rules and rates for the future are unknown and highly unpredictable. Given the state of the federal deficit it is possible that some type of "Value Added Tax" or other type of tax rate change will be needed to restore government solvency.

It is possible that all the compelling reasons to convert to a Roth today might not be as compelling when the qualified plan owner dies. Situations and life events could be dramatically different in the future. Remember, although the intent of the policy was to pay for a Roth conversion, the new life policy proceeds can be

used for anything. The surviving spouse can make the call on the Roth conversion when more is known about pressing needs and lifestyle requirements that exist in the future.

Setting up a life policy also offers another opportunity: the policy can be placed into an irrevocable life insurance trust (ILIT). The trust can be used to shift qualified money out of the taxable

estate. This is another example of the flexibility and choice that buying life insurance offers to clients.

As we go through these times of change and challenges, especially as it relates to helping clients achieve financial security, it's important to stay on the cutting edge by offering solutions with the flexibility to meet a number of needs. Remember when life policies were most often sold to couples to replace the loss of a wage earner, pay for college educations and retire mortgages? Today, as baby boomers move through their life cycle, life insurance now can be placed in force to help pay for things such as Roth conversion taxes, lost Social Security income, lost pension income, Medicare taxes and prescription drugs. That's why it's important to remember the life insurance option when discussing Roth conversions. If clients like what Roth conversions can do but do not have the cash to pay the taxes at this time, they just might like the opportunity to pay a small premium now, guarantee the ability to fund a Roth conversion down the road, and know that their life insurance can be the solution to a variety of different situations over the long term. **INN**

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year. In this example, at age 70½ the RMD on \$500,000 of qualified money equals \$18,248. This is a taxable withdrawal, so it should be discounted to a net after-tax amount of +/- \$14,000.

Assume the qualified plan owner is a female age 65 and in good health. Based on standard rates from a nationally known company, she could qualify for a \$673,970 GUL life policy. Using a

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