Protecting Your Client (and Your Practice)

IRA-to-IUL Conversion Strategies

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Protecting Your Clients. Protecting Your Practice.

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 advisors – are realizing deferring taxes may not be in their best financial interest.

But while in the past most 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* to grow funds securely
- *Tax-free income* through policy loans
- Access to funds with *no market-value adjustment*
- A *legacy for heirs* above the account value

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

What is an IRA-to-IUL Conversion?

An IRA-to-IUL conversion is a process by which a client withdraws a portion of his or her IRA funds, pays taxes on the proceeds, and uses the net amount to purchase a permanent life insurance policy that builds cash value.

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

An IRA-to-IUL conversion can be part of a holistic planning approach to maximize and balance the growth, security and tax benefits of your client's overall portfolio.

Is an IRA-to-IUL Conversion Strategy Sound?

The answer is yes, with important qualifications.

Like many financial strategies, IRA-to-IUL conversions can be beneficial for some clients, while not appropriate for others. Additionally, as with any insurance strategy, proper structuring of the policy is critical to ensure the client's best interests are met.

When a client has been properly qualified and an IUL policy has been properly structured, an IRA-to-IUL conversion strategy can be an integral part of retirement planning.

In fact, the approach recommended in this white paper has been reviewed and approved by teams of CPAs.

Many previous attempts at IRA-to-IUL conversion strategies by carriers and other industry players have been controversial. Some strategies relied on unrealistic IUL illustrations, or policy 'tricks' that create fragile plans. You'll notice this white paper identifies the correct way to approach an IRA-to-IUL conversion to avoid these pitfalls.

At its core, an IRA-to-IUL conversion strategy is a two-step decision-making process for you and your client:

1. Does it make sense for your client 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 any advisor recommending an IRA-to-IUL conversion strategy must consider. By addressing each of these areas, you can determine if this approach is right for your client, and how to best execute the strategy.

#1: Make sure your client is a good fit for this strategy

Most of the time, an IRA-to-IUL conversion strategy is not appropriate for your client's entire IRA account balance. So make sure your client has a portion of his or her IRA that can be allocated to this strategy.

- Funds in an IUL policy need time to accumulate. Therefore, an IRA-to-IUL conversion should only be used for the portion of your client's IRA that is not needed for income in the next 10 years.
- Remember: an IRA-to-IUL conversion is just one piece of your client's retirement planning strategy.

#2: Analyze your client's IRA to make an informed decision

How do you know if an IRA-to-IUL conversion will improve your client's retirement approach? Start by analyzing their current IRA.

A good analysis should include:

- *Total tax liability*: How much in taxes will the IRA generate over the client's lifetime? Based on this analysis, you and your client can decide if moving IRA funds from a tax-deferred status to a tax-free status makes sense.
- If the answer is yes (it makes sense to move funds to a tax-free status), 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

Now, you can compare after-tax growth in your client's IRA to after-tax growth in an IUL policy.

It's important to structure the IUL policy appropriately to create a true comparison. Steps 4 and 5 will help you do so.

#4: Handle taxes responsibly

Your client will owe taxes on the funds coming out of his or her IRA. Helping your client determine the best approach for paying those taxes is critical to setting up a successful IRA-to-IUL conversion strategy.

- IUL premiums should be set using post-tax amounts from the client's IRA.
  - For example, if your client is withdrawing $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).
- Your client should not use IUL policy loans to pay taxes.
  - For example, the client 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 client's IUL policy at risk. Early-year loans can stress an IUL policy, particularly if indexing returns 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.

#5: Structure the IUL policy appropriately

There are two key components to structuring an IUL policy appropriately:
- How the policy is funded (premium pattern)
- How the death benefit is set

Premiums
It's important your client fund his or her IUL policy in the most 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 MEC, as loans from a MEC are not tax free.

A <u>5-pay premium</u> is generally the ideal structure for an IRA-to-IUL conversion strategy.
- A 5-pay moves premiums into the policy quickly while ensuring 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 10-pay may be appropriate to avoid moving the client into a higher tax bracket in any given year.

Death Benefit
The death benefit is an important consideration. After all, IUL can deliver something your client's IRA cannot: A legacy above and beyond the account value.

- In an IRA-to-IUL conversion strategy, it will often make sense to set the death benefit at the minimum allowed by IRS guidelines (available in your carrier illustration software).
    - This minimum death benefit will ensure the policy does not become a MEC, and the tax status of your client's funds will not be at risk.
- You should <u>not</u> 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.

#6: Be a good fiduciary

In today's compliance environment, it is critically important to handle an IRA-to-IUL conversion strategy appropriately. This includes several factors:

- *Follow your analysis*: Make sure IUL is a better strategy than keeping your client's money in an IRA. Many times, the analysis above shows IUL to be the superior strategy – but not always. Let the analysis guide you and your client's decision.

- *Make sure there are assets for early-year income*: Your client's IUL policy will need time to accumulate cash value. Be sure your client has other assets to provide income in the early years of retirement. A good rule of thumb is premiums should accumulate in an IUL policy for a minimum of 10 years.

- *Evaluate cost*: Cost is one factor that can help establish why a client may be better served by an IRA or IUL strategy. Look at the potential cost of both the IRA and the IUL policy over the lifetime of the account and policy.

- *Act as a fiduciary*: In compliance with PTE 84-24 and other regulations, your analysis becomes the financial justification for an IRA-to-IUL conversion. If the calculations show better potential benefits from an IUL policy, it is within your fiduciary responsibility to recommend that strategy.

- *Record your client's decision*: Be sure to keep a file with your analysis for any client who chooses an IRA-to-IUL conversion strategy. You and the client can sign an acknowledgement of strategy decision – in addition to other PTE 84-24 forms – establishing why this strategy was chosen.

IRA-to-IUL conversions are growing in popularity for good reason. The strategy can be a powerful and responsible choice for your clients when good business practices are followed and a complete analysis has been performed.

As this growing strategy continues to evolve, it is critical financial advisors approach IRA-to-IUL conversions conservatively, compliantly and with the best interests of their clients in mind.

Martin Ruby, FSA is an actuary and CEO of Stonewood Financial. Martin has decades of experience developing, pricing and selling insurance products. He drove the creation of one of the very first Universal Life products, and is one of the industry's leading experts on Indexed Universal Life insurance. Previously, Martin served as CEO of Integrity Life Insurance Companies and was a senior executive at Capital Holding Corporation (now part of AEGON).

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