8 Reasons Whole Life Insurance Is Not Like A Roth IRA

The Author in Pine Creek Canyon, Zion National Park

The posts on this website about cash value insurance continue to attract comments (mostly from those who sell it) like a knight in shining armor on a summit in a thunderstorm attracts lightning. Months or even years after I write a post the comments continue to grow into the hundreds. In a recent comment, one agent stated that whole life insurance was a lot like a Roth IRA. I've heard that comparison many times, but it is flat out wrong, so I called him out on it. This post goes in to more detail about the reasons why whole life insurance is not like a Roth IRA.

1) No Interest Free Withdrawals

The reason some people fall for this scheme is that the money in a whole life insurance policy does grow in a tax-protected manner, and when you borrow the money from the policy later in life (remember you can't withdraw the money, because that's taxable, so you borrow it), it comes out tax-free "just like a Roth IRA." However, it is not interest-free. Just like when you borrow from a bank, when you borrow from an insurance policy you have to pay interest. It doesn't seem fair, I know, but that's the way life insurance works. You have to pay interest to borrow your own money. When you withdraw from your Roth IRA, you owe neither taxes nor interest.

2) Excessive Fees Lower Returns

Roth IRAs can be extremely inexpensive. There is no fee at all to open one at Vanguard. They also have no closing fees. The expense ratio for investments can be as low as 0.05% a year. Try comparing that to the typical whole life policy. The insurance policy not only has a number of "garbage fees," but since these things don't sell themselves, the insurance company has to compensate its salesmen with large commissions (typically 40-80% of the first year's premium) in order to get any business at all. The more you pay in fees, the less that goes toward the investment, and the lower your returns.

3) Insurance Costs Lower Returns

Since whole life insurance is a hybrid insurance/investing vehicle, it requires you to purchase insurance, whether or not you want it. All the money that goes toward the cost of that insurance by definition cannot go toward your cash value, so your investment will grow slower, producing lower returns.

4) Complexity Favors The Issuer

It is very easy to open a Roth IRA. It's a simple proposition. You put in after-tax money, it grows tax-free and it comes out tax-free in retirement. You can put any reasonable investment inside it- stocks, bonds, mutual funds etc. Fees are clearly disclosed and, if you go to the commonly used mutual fund houses, quite reasonable. Insurance policy prospectuses, however, are hundreds of pages thick. Even the illustrations run dozens of pages. The fees are usually buried somewhere deep inside. I run into physicians every week who have been sold one of these policies who really didn't understand what he was buying. In general, complex financial instruments favor the issuer over the purchaser.

5) No High Rate Of Return Investments Available

When your invest through an insurance company (which is what you are doing with whole life insurance) you're stuck with the dividends that they want to pay you. Their dividends are limited by the investments that they use. These investments tend to be very conservative, often composed of 80-85% bonds. A Roth IRA, of course, can be invested in all kinds of investments with higher expected rates of return, such as US stocks, International stocks, REITs, small value stocks, emerging market stocks or even commodities.

6) You Cannot Stop "Investing"

With a Roth IRA, if you make less in any given year or just decide you want to blow your money on a boat, you can do that. Not so with a life insurance policy. If you don't pay the premiums, the policy will lapse. Proponents will argue that after a certain number of years, the dividends from the policy will be sufficient to pay the premiums. That may be true, but that period of time always seems to come much later than the initial projections. It may be 2 or even 3 decades before the policy can pay its own premiums, dramatically reducing your financial flexibility.

7) Different Asset Protection And Estate Planning Treatment

Roth IRAs and whole life insurance may be treated very differently when it comes to asset protection and estate planning issues. Depending on the state, some or all of your

Roth IRA may be protected from creditors. The same goes for the cash value in a whole life insurance policy. In some states one is protected more than the other, and vice versa in other states. In some states neither receives much protection, and in other states both are completely protected. The point is they aren't substitutes for each other.

The same goes with estate planning issues. A Roth IRA passes to heirs income tax-free but subject to any possible estate taxes. It can be "stretched" to allow for additional years of tax-free growth for heirs. The cash value of a whole life insurance policy disappears when you die, and your heirs are paid the death benefit (minus any money you borrowed out of the policy) without having to pay income or estate taxes on it. Any additional earnings on that money, of course, would be fully taxable to the heirs. The money in both a Roth IRA and whole life insurance passes to heirs outside of probate. Both have their positive aspects, but they are very different.

8) Must Be Insurable

One of the biggest issues with investing in a life insurance policy is that the worse you are as an insurance risk, the worse the investment gets. If you are unhealthy, have bad habits like smoking, or engage in risky pursuits like climbing, parachuting or SCUBA diving, then the insurance costs in the policy will skyrocket, if they'll even issue you a policy. You also have to go through blood and urine tests and give out detailed private information about your health and habits. All you need to open a Roth IRA is income and a social security number. Since you can't really save much for retirement without those things, it's a pretty lower hurdle to get over.

The bottom line is that whole life insurance IS NOT like a Roth IRA, and anyone who tries to equate the two is likely trying to earn a commission by selling you whole life insurance. To make matters worse, a lot of these salesmen don't even know that high earners can still contribute to a personal and spousal Roth IRA through the backdoor. Whole life insurance is a bad enough investment when used in addition to a Roth IRA; it's downright horrible when used instead of one.

What do you think? Have you heard agents using this line? What other differences or similarities do you see between a Roth IRA and whole life insurance? Comment below!