

Roth IRA vs. Life Insurance: Which is Best for Your Legacy Goals?

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Which strategy is best for your legacy goals? Understand the tax implications, benefits and drawbacks of each strategy.

By S. Joseph DiSalvo and Marie L. Madarasz

Picture three friends sitting down for coffee, all recently retired and reflecting on their financial futures.

- **Mark** leans back in his chair and grins, “I worked hard for my money and I plan to spend every dollar of it. My kids got a good education, they’re on their feet and I want to enjoy my retirement to the fullest.”
- **Susan** nods, “I feel the same way... mostly. My retirement savings are first and foremost for me, but if there’s something left over, I’d like my kids to have it—just like my parents did for me.”
- **Tom** chimes in, “For me, it’s different. I want to make sure my wife and I can cover our expenses without burdening our kids, but more than anything, I want to leave them a strong financial legacy.”

These three perspectives represent the most common approaches we see as wealth advisers. While each requires a tailored financial plan, Tom’s mindset—the desire to grow and protect wealth for the next generation—is where estate planning becomes particularly critical.

Recently, we worked with a couple just like Tom. Their goal was clear: protect their assets and pass on as much as possible to their three children. They had witnessed firsthand how long-term care costs and estate taxes can erode an inheritance. Their mission? To ensure their legacy wasn’t diminished by avoidable expenses, unnecessary taxation or government intervention.

Due to the high federal estate tax exemption of \$13.99 million per spouse, planning for a federal estate tax at death was not their main concern. However, with \$4 million in investable assets—\$3 million of which was in pre-tax IRAs—the challenge for avoiding a New York estate tax was of more concern, but not insurmountable. (The New York estate tax exemption amount is \$7,160,000. Unlike the federal estate tax exemption, it is not portable.) The key question became: Of the many tools they can consider, which would help them achieve their goals?

Step One: Protecting Wealth From Long-Term Care Costs

One of the biggest threats to wealth preservation is unexpected medical costs. Nursing home care, for example, can cost upwards of \$100,000 per year. Medicaid, the safety net program for long-term care, only steps in once personal assets have been depleted. The couple had seen this happen firsthand with one of their parents and they were determined to avoid the same fate.

To shield their assets, we helped them establish an irrevocable trust. By transferring their joint investment accounts and real estate into the trust, they ensured these assets would no longer be counted for Medicaid eligibility purposes. Their children were named as trustees and while they could continue receiving income from the trust, the principal remained protected.

With this step complete, their real estate and non-IRA assets had safeguards in place. But what about their pre-tax retirement accounts?

Step Two: Managing the \$3 Million IRA Challenge

A major portion of their wealth, \$3 million, was tied up in traditional pre-tax IRAs. The issue? These accounts would be subject to required minimum distributions (RMDs) starting at age 73, triggering potentially large tax bills. Even worse, if passed directly to their children, these accounts would be taxed as ordinary income and most likely be subject to the SECURE Act's 10-year distribution rule, potentially pushing their heirs into higher tax brackets.

The couple was in prime position to work to optimize their tax planning. They were in their mid-60s, had a small pension and hadn't yet claimed Social Security. Their taxable income was low, keeping them in the 22% bracket—a perfect time to consider tax-efficient wealth transfer strategies.

The Two Best Options: Roth Conversions or Life Insurance?

To address the tax challenge, we narrowed the strategy down to two primary solutions:

1. **Roth IRA Conversions**
2. **Permanent Life Insurance**

Both offer tax advantages, but they work in fundamentally different ways. Let's explore the differences.

Option 1: Roth IRA Conversions - Paying Taxes Now for a Potentially Tax-Free Future on Your Roth Account

Think of a Roth IRA conversion like prepaying taxes on an inheritance. Instead of leaving their children a taxable IRA, the couple could convert portions of their pre-tax IRA into a Roth IRA each year while staying in a low tax bracket. Each situation is unique and should be examined carefully to help ensure you are not triggering any further taxation.

The Benefits:

- **Tax-Free Growth & Withdrawals:** Unlike traditional IRAs, Roth IRAs grow tax-free and can be withdrawn tax-free in retirement.
- **No RMDs:** Unlike traditional IRAs, Roth IRAs do not require distributions during the account owner's lifetime, allowing for greater tax-free compounding.
- **Tax-Free Inheritance:** When the children inherit the Roth, although still subjected to the 10-year distribution rule, they won't owe income taxes on withdrawals.

By systematically converting portions of their IRA each year (up to their tax bracket limit), they could gradually transition their wealth into a fully tax-free inheritance for their children. However, the "I" in Roth IRA stands for individual, meaning it will always be included in the taxable estate.

Option 2: Life Insurance - Guaranteed, Tax-Free Wealth Transfer

Now, imagine you could write a check to your children today, knowing they'd receive it tax-free, no matter what happens in the markets. That's essentially what a well-structured permanent life insurance policy does.

With this strategy, our clients would use withdrawals from their IRA, pay the tax due, and then use net dollars to pay premiums on a permanent life insurance policy. The policy would then provide a guaranteed tax-free death benefit to their children.

The Benefits:

- **Income Tax-Free Death Benefit:** Life insurance proceeds are not subject to income tax, unlike inherited IRAs.

- **Market-Proof:** Unlike investment accounts, the death benefit remains guaranteed, regardless of economic conditions.

- **Potential Estate Tax Protection:** If structured properly in an irrevocable life insurance trust (ILIT), the policy proceeds can also be excluded from the estate, reducing estate tax exposure.

So, Which Strategy Was Best?

Ultimately, we recommended a hybrid approach:

- Partial Roth conversions to move taxable IRA money into a tax-free Roth IRA gradually.
- A permanent life insurance policy to create a guaranteed, tax-free inheritance for their children.

By combining both strategies, they gained the benefits of both —a tax-free retirement vehicle (Roth IRA) and a guaranteed wealth transfer tool (life insurance).

Final Thoughts: What's Right for You?

If you're like Mark, Susan or Tom, your retirement and legacy goals will shape the strategy for your wealth. There's no one-size-fits-all solution, but by understanding the key differences between Roth IRAs and life insurance, you can make a more informed decision:

Bottom Line:

If you're looking to leave a legacy to your heirs when you die, there are many tools to consider. Life insurance and Roth IRAs are but two of the many options we've chosen to contrast here today. Keep in mind that life insurance may not always be available due to poor health. The bottom line is that every situation is different and there's no one-size-fits-all solution. Do your homework, seek competent advice and give yourself a legitimate opportunity to achieve your goals. By taking a proactive approach, you can work to ensure your hard-earned wealth stays with your loved ones rather than being lost to taxes, long-term care costs, or government intervention.

Which path will you take?

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S. Joseph DiSalvo, ChFC®, and Marie L. Madarasz, AIF, authors of "Income for Life, The Retiree's Guide to Creating Income from Savings," specialize in coordinating a retiree's income, investment and tax planning. They are members of Ed Slott's Elite IRA Advisor

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Download our whitepaper, [The Consumer's Guide to Partial Roth Conversions](#) to learn how to think through and implement this strategy.

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